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PLANNING AMERICA: GOVERNMENT OR THE MARKET?

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PLANNING AMERICA: GOVERNMENT OR THE MARKET? INTRODUCTION

James A. Dorn

The question of whether the future of American industry should be left to the "blind forces of the marketplace" or whether "rational" economic development requires "better" government planning and greater "cooperation" among government, business, and labor is of fundamental importance. In order to address this question and to consider the various criticisms of the market system, the Cato Institute sponsored the conference "Planning America: Government or the Market?" in Washington, D.C., April 27–28, 1984. The conference papers, along with articles by Sakoh, Trezise, Vieira, and DiLorenzo, provide a comprehensive treatment of the major issues surrounding the industrial policy debate.

The current notion that America's future economic development cannot be left solely to market forces is by no means novel. It has long been argued that industrial development requires "rational" and "better" government planning, and that a "cooperativist" approach to planning is superior to the perceived "individualistic" approach of the market.[1] This was the position taken in the 1930s when legislative activists of the New Deal era tried to institutionalize "codes of fair competition" as part of the National Industrial Recovery Act, later declared unconstitutional in *A.L.A. Schechter Poultry Corp. v. United States*.[2] It was further represented by the Reconstruction

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[1]In fact, the individualistic approach of the market is wholly consistent with cooperation, properly understood as the *voluntary* exchange of goods and services. The free market is a mechanism for generating cooperation and mutually beneficial exchanges. On the difference between "true individualism" (which is characterized by "the spontaneous collaboration of free men") and "false individualism" (which is characterized by collectivism and the use of government coercion to achieve some preconceived plan), see Hayek (1948, chap. 1).

[2]295 U.S. 495 (1935). For a discussion of this case, see Vieira (1976, pp. 601–4).

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Finance Corporation (RFC) as it operated during the 1932–53 period to influence the allocation of capital (see Yeager 1977). More recently, it found expression in the Balanced Growth and Economic Planning Act of 1975 (see Hayek 1978, pp. 245–46).

Current proponents of industrial policy such as Robert Reich, Felix Rohatyn, Lester Thurow, Lee Iacocca, and Congressman John J. LaFalce continue the cooperativist tradition. All call for a tripartite council consisting of representatives from government, business, and industry, whose function would be to create a "national consensus" for industrial development. Proponents of industrial policy also advocate a development bank that could help channel investment funds to those areas targeted by the tripartite council or some other agency. The private sector would provide the bulk of investment funds, but the development bank—a type of RFC—would help allocate credit to where the "planners" thought it was most productive.

These ideas have found content in the 1984 Industrial Competitiveness Act (H.R. 4360), whose primary architect was Congressman LaFalce. The key provisions of that act are the establishment of a Council on Industrial Competitiveness and a Bank for Industrial Competitiveness. The tripartite council would seek to adopt a strategy for industrial development that would replace the current patchwork of government development programs—regulations, tax incentives, subsidies, trade policies, and so on—with a coordinated and consistent set of policies designed to achieve a broad consensus and foster economic growth. The development bank would be a major tool for implementing this new industrial policy.

Throughout the literature on industrial policy, one can find repeated references to the notion that the world is too complex to allow the market to determine the future industrial pattern of the United States. The government must impose order on an otherwise chaotic market system, and it can do so without sacrificing personal and economic freedoms. What is proposed, say advocates of the new industrial policy, is not comprehensive central planning but a type of "indicative" or "voluntary" planning. Furthermore, these proponents claim that since we already have government planning, we should at least try to make it more efficient. Lee Iacocca, for example, recently stated: "[A]ny debate over *whether* the [United States] should have an industrial policy is outdated and way off course. We already have one but it's all messed up. The real issue is should we have a *rational* industrial policy" (1984, p. 4). Thurow has argued in a similar vein: "The most compelling argument for industrial policies is . . . the argument that we already have industrial policies and that it is in fact impossible for a democracy not to have industrial policies. Every

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tariff, every quota, every allocation of credit, every bail-out is an industrial policy. It is just a terribly inefficient back door industrial policy" (1983, p. 178).

Industrial policy advocates, however, are not simply rejecting the current piecemeal approach to development planning; they are also expressing their distrust of the free market, especially in the area of investment decision making. Thurow, for example, argues that "[m]ajor investment decisions have become too important to be left to the private market alone. . . . Japan Inc. needs to be met with U.S.A. Inc." (1981, p. 192). The same distrust is found in Reich's proposal for a "national bargaining arena" where the distribution of the benefits and costs of adjustment policies could be determined and where "government, business, and labor" could "fashion explicit agreements to restructure American industry" (1983a, p. 107).

Nevertheless, advocates of a cooperativist approach to industrial policy deny they are anti-market; they would argue only for limited government planning and against comprehensive central planning of the economy. Rohatyn, for instance, stated in congressional testimony: "I am opposed to government planning and to government-owned industries. I believe that the free market is usually the best market. However, the free market is not always adequate and not always right" (1984, p. 97). According to Thurow: "The problem is not 'the market' versus 'planning', but how planning can be used to improve one's market performance. . . . Whatever one believes about the virtues of unfettered free enterprise, empirical feedback indicates that 'success' is not occurring automatically. What used to work won't work. For the world has changed" (1983, p. 173).

We are left with the feeling that somehow unconstrained markets cannot work as well as government-aided markets; that free markets do not generate adequate information and fail to coordinate economic activity; that cooperation is better achieved via tripartite councils than via market competition; and that Adam Smith's invisible hand of competition must be supplemented with the visible hand of government to achieve industrial growth (see Nutter 1983, chap. 15).

One becomes suspicious, however, that underlying all these criticisms of the market is a basic dissatisfaction with the distribution of income and the pattern of production generated by the competitive market process. This is confirmed by Reich: "[I]n the emerging era of productivity, *social justice* is not incompatible with economic growth, but essential to it. A social organization premised on equity, security, and participation will generate greater productivity than one premised on greed and fear" (1983b, p. 20; emphasis added). The implication, of course, is that "equity, security, and

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participation" can best be achieved by the type of industrial policy advocated by Reich and his fellow travellers, while the market, which is characterized by "greed and fear," is largely responsible for the demise of U.S. productivity growth.

In contrast, advocates of the free market argue that in a world of scarcity, where knowledge about wants, resources, and technology is costly, some type of planning is inevitable. But, market proponents claim, it is individual planning via the use of market prices, profits, and mutually beneficial adjustments to changing conditions—not greater government planning—that is essential for economic coordination and development in line with consumer preferences. The idea that greater "cooperation" between government officials and market participants can somehow improve the flow of information and resources is a red herring—it ignores the fact that the market process and the political process are necessarily different.

Market cooperation (competition) is based on *voluntary* exchange: There must be consent among all parties to an exchange for the exchange to take place; that is, there must be unanimity. The fact that third parties—those outside the direct exchange—are harmed by changing prices and patterns of production is irrelevant, for these parties have no legitimate right to prevent consumers from choosing a preferred combination of resources and products. The competitive market process, which Hayek has called a "discovery procedure," is based on private property rights with prices and profits providing the information and incentives necessary to guide resources to where they have their highest-valued uses, as determined by *consumers*.[3]

From the Hayekian perspective, the economic problem is basically a knowledge problem: "[H]ow to secure the best use of resources known to any of the members of society, for ends whose relative importance only these individuals know. . . . a problem of the utilization of knowledge which is not given to anyone in its totality" (Hayek 1948, p. 78). Thus, according to Hayek (pp. 83–84):

> If we can agree that the economic problem of society is mainly one of rapid adaptation to changes in the particular circumstances of time and place, it would seem to follow that the ultimate decisions must be left to the people who are familiar with these circumstances, who know directly of the relevant changes and of the resources immediately available to meet them.

Awareness of the limitations of human knowledge, the impossibility of centralizing all the information that would be relevant for

[3]According to Hayek, competition is "a procedure for the discovery of such facts as, without resort to it, would not be known to anyone, or at least would not be utilized" (1978, p. 179).

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allocating resources in line with consumers' preferences, and the danger to individual freedom that arises from government planning led Hayek to conclude that the major function of government should be to protect private property rights, including freedom of contract. Hayek argued that if the government limited itself to "the enforcement of universal rules of just conduct, protecting a recognizable private domain of individuals, a spontaneous order of human activities of much greater complexity will form itself than could ever be produced by deliberate arrangement" (1967, p. 162).[4]

Hayek would dispute Reich's claim that "social justice"—by which Reich means distributive as opposed to commutative justice—is a necessary condition for economic growth. For Hayek the pursuit of social justice must disrupt the market order, which depends on private property and freedom of choice. Moreover, the very notion of social justice (as a public policy goal) is misleading for Hayek because there is no way to arrive at an objective measure to determine beforehand the distribution of income that is deemed socially optimal. From this it should be clear that any attempt to rearrange the market distribution of income, which is the result of a voluntary process of serving consumers' interests, must of necessity result in coercion. And, if individuals value freedom because it provides them the greatest opportunity to utilize their talents, the necessary information to satisfy their wants, and the incentive to serve other consumers in an efficient manner, then the loss of this freedom can be expected to reduce—rather than increase—individual and social welfare.[5]

The political process under government planning would be fundamentally different from the impersonal market process. Public choice theory teaches that the absence of residual claimants in government and the incentive to cater to special interest groups result in the rent-seeking activity we are witnessing today. Bureaucrats, like other individuals, are self-interested—they pursue those activities

[4]"That we have been able to achieve a reasonably high degree of order in our economic lives despite modern complexities," says Hayek, "is *only* because our affairs have been guided, not by central direction, but by the operations of the market and competition in securing the mutual adjustment of separate efforts. . . . What the marketplace and its prices give most particularly is a continuing updating of the ever changing relative scarcities of different commodities and services. . . . the complexity of the structure required to produce the real income we are now able to provide for the masses of the Western world . . . could develop *only* because we did *not* attempt to plan it or subject it to any central direction, but left it to be guided by a spontaneous ordering mechanism, or a self-generating order, as modern cybernetics calls it" (Hayek 1978, p. 237).

[5]For a fuller discussion of the notion of justice in general and social justice in particular, see Hayek (1982, chap. 9; 1978, chap. 5 and p. 238; 1972, pp. 231–33). Also see Dorn (1981), Nozick (1974), and Pilon (1981, 1982, 1983).

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that will increase their net benefits, subject to the constraints facing them. The rewards they can capture and the costs they must bear for different activities will largely shape their behavior. With no profit/loss test within government, there is no reason to believe that government officials will follow the so-called public interest. Without strict constitutional limits on the scope of government action, it is difficult to see how Reich-type industrial policy proposals could avoid increasing this rent-seeking behavior.[6] When tripartite councils are substituted for the decisions of private market participants, the marketplace necessarily becomes politicized, and special interest groups will use the political machinery to impose their will on the general public.

Before we can accept the claims of Reich and other proponents of an activist industrial policy, the following questions must be considered in more detail. What type of institutional arrangement—government or the market—would best protect economic liberties and best satisfy consumer preferences? What are the effects of each planning arrangement and each type of competition—political competition and price competition—on the coordination of individual plans; and what planning mechanism would provide a more stable framework for making rational decisions about production, employment, consumption, and investment? Is the role of the government one of setting the rules of the game and then letting the market allocate resources? Or should the government push the market in the direction favored by some tripartite council dominated by large corporations and major unions? Most important, how will government planners or tripartite council members utilize the relevant information about wants, resources, and technology that is only available to individual market participants, and that can only be transmitted through the market process? Finally, how will alternative modes of competition and economic organization—one based on political or forced cooperation and the other on market or voluntary cooperation—affect the types and costs of information generated and the incentive to innovate and discover new information in a dynamic economy?

In addition to these questions, any serious discussion of industrial policy must consider the following five points.

1. In choosing between alternative industrial policies, or alternative methods of organizing economic activity, one must avoid falling into the trap of taking what Demsetz (1969, p. 1) calls the "*nirvana*

[6]For a useful discussion of the current developments in public choice theory, the nature of the rent-seeking argument, and the benefits of constitutional limits on the power of government, see Buchanan and Tollison (1984).

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approach": The view that the relevant policy choice is "between an ideal norm and an existing 'imperfect' institutional arrangement." For example, economists who attack the existing market mechanism because it deviates from the static model of perfect competition and then point to that deviation to justify government intervention are committing the nirvana fallacy. A more effective approach to policy appraisal, says Demsetz (p. 1), is the "*comparative institution* approach," in which the relevant policy choice is between existing institutions, all of which are imperfect. We can then ask how different ways of organizing industry and commerce would affect incentives and economic behavior, as well as consumers' sovereignty.

Taking a comparative institution approach does not mean we have to throw out all our theoretical models. It does mean, however, that we should examine existing institutions as they are and then use our theory to try to improve those institutions. This approach to policy questions, for example, would have us consider whether we can improve existing institutions so they approach more closely the requirements for a competitive market process. The comparative institution approach warns us that if the behavior of market participants deviates from the norm of perfect competition, the behavior of government agents also deviates from the results predicted by the public interest theory of government.

2. We must remember that generating consensus for economic change via the political process is significantly different from reaching agreement via the market process. These two processes for cooperation represent the difference between a discretionary approach to resource allocation and one based on constitutional rules that provide a framework for individual choice. Public choice theory has shown that in a democracy, majority rule does not guarantee results consistent with individual preferences. Likewise, there is no reason to believe that imposing democratic (majority) rule on the marketplace through tripartite decision making would lead to an allocation of resources that satisfies consumer preferences better than the free-market alternative based on a unanimity rule for each individual transaction.[7]

[7]Drawing on Hutt's work (1975, chap. 5), it could be argued that tripartite councils are inconsistent with true democratic government—since they interfere with constitutional rules that would minimize coercion—and with what Hutt calls "*democratic* consumers' sovereignty." On this latter point, Hutt argues: "[W]hen the framework of institutions releases and safeguards the loss-avoidance, profit-seeking incentives as far as is practicable, we can call the *consumers' sovereignty* exercised 'democratic.' The adjective 'democratic' is apt when the sovereignty expressed reflects the forecast choices of all income receivers through a system of voting under which each person's vote about how the community's resources shall be utilized is weighted in proportion to the value of the productive services that he and his property (whether acquired through his

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3. It is an illusion to think that a government-business-labor council (or even a council of saints) could outperform the market in gathering the information relevant to satisfying consumer preferences for both present and future consumption—the information simply is not available to a centralized body, nor could it be discerned from statistical data (see Hayek 1948, chap. 4). Moreover, in reality, the council would be subject to political pressures and would redistribute resources and income to where it was most politically expedient. In the process information that is politically valuable will come to the surface, but information that is of value to consumers and resource owners will remain submerged—distorted by government meddling in the price and profit system.

The market is a process of trial and error, and one in which it pays individuals to correct their errors as quickly as possible. Consequently, although specific errors will always exist in the market economy, we can expect these errors to disappear as new information is generated and individuals adjust to new patterns of prices and profits. If private property rights are well defined and protected and there is a stable monetary framework, the market system will not allow errors to accumulate—crises will be minimized and resources will flow to their highest-valued uses. Under government planning, however, both the lack of a profit/loss test and bureaucratic inertia would slow the adjustment process. Errors would accumulate until a crisis occurs. Government planning would be characterized by politically motivated adjustments to periodic large-scale crises, while market planning would be characterized by continuous voluntary adjustments through a system of markets and prices, which would prevent serious crises. Of course, if the free-market process is impeded by price controls or overregulation, it too will fail to bring about smooth adjustments to changes in the basic economic data.

G. Warren Nutter has considered the above differences between the market adjustment process and government planning as they affect the use of knowledge. According to Nutter: "The effort to impose conformity on the market's multitude of forecasts has many adverse consequences, a serious one being the compounding of probable error. . . . That is, the likely mistake inherent in a centralized forecast will have a more harmful impact on the economy than the variety of mistakes distributed among individual forecasts, since the very spread in the latter, involving overlapping margins of error, generates

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thrift—or his parents') are contributing to the common pool of output" (p. 82). Hutt (1936) was apparently the first to use the term "consumers' sovereignty" (see 1975, p. 95, n. 11).

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differential market adjustments that diminish average forecasting error over time" (1983, pp. 118–19).

For Nutter, "to predetermine 'growth' is to forestall it" for "[w]e cannot know in advance the 'optimum' way out [of a "jungle of ignorance"] or what lies on the other side. We grope our way forward" (1983, p. 46). Carrying this point further, he states: "There is no mystery as to why efforts to forecast economic structure . . . should fail in complex Western economies. In the West, the great engine of progress has been innovation, which by its very nature cannot be foreseen or planned in detail. The best path of progress is the one that unfolds as the economy moves along . . ." (1983, p. 122).

Given the choice between adjustment mechanisms, Nutter would opt for the market—he sees it not only as a faster adjustment process, but as one that is more responsive to consumer choice and hence more compatible with freedom of choice. In commenting on the Balanced Growth and Economic Planning Act of 1975, which has certain features in common with current cooperativist proposals for industrial policy, Nutter says that if such a scheme were implemented "consumer sovereignty would go out the window. All important economic decisions would be made politically. . . ." And "[p]rivate enterprise might become so weakened and circumscribed that the market itself would cease to be an effective coordinative mechanism" (1983, p. 126).

Because of the grave dangers posed by a movement away from voluntary planning through the market process and toward democratic planning through the political process, Nutter emphasizes that the burden of proof ought to rest with those who want to change the market system. As it stands, "[t]he planners try to place the burden of proof on those who wish to preserve the traditional American economy—and then they rule out all possible proof." But, Nutter argues: "In proposing such a profound and far-reaching transformation of American society, they bear the responsibility for proving that the new order will be better than the one to be displaced" (1983, p. 128).

4. The claim often heard among advocates of an activist industrial policy is that the cost of implementing their policy proposals would not be prohibitive. But this is misleading. Underlying many of the arguments about how inexpensive a cooperativist industrial policy would be is the myth that in a less than fully employed economy, there is a zero opportunity cost for expanding government control over resources. But this argument fails to recognize the nature of opportunity costs: Even at less than full employment, the use of resources by government means that those resources are being diverted

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from alternative uses. If these alternative uses are preferred by consumers to the government's uses, there will be a net loss of wealth for consumers; that is, the new industrial policy will have cost society (consumers) more than it is worth.

5. Finally, the notion that a little government intervention does not pose a threat to economic and personal freedoms must be questioned. Both Hayek and Friedman, among others, have shown that once the government interferes in the market process, there is a high probability that further intervention will be necessary to carry out the "plan."[8]

Those who favor a free-market approach to organizing economic activity (or to "planning America") argue that these five points seriously challenge the conventional wisdom that activist industrial policy, or a consensus imposed by the political process, can improve the pattern of development generated spontaneously by the market order. The burden of proof must rest with Reich, Thurow, Iacocca, LaFalce, Rohatyn, and others who propose to change the current system. It is true that the existing system falls short of the free-market ideal, but these individuals wish to move away from, not toward, a more competitive market economy. Market advocates, on the other hand, seek to move closer to a free market by lowering marginal tax rates, getting rid of the regulatory apparatus that stifles innovation, protecting property rights, and enhancing freedom of choice.

Those who favor an activist/cooperativist industrial policy must convince us that the government is superior to the market in satisfying consumer preferences. Otherwise, they must revert to crude arguments for social justice. Of course, it may well be that those arguing for an activist industrial policy do so precisely because they are dissatisfied with the existing distribution of income and would like to impose their ideal of social justice on the market order via the political process. Indeed, the earlier reference to Reich (1983b, p. 20; supra, p. 367) implies that he would readily accept social justice as a public policy goal. Reich is at least being honest, though he naively believes the pursuit of social justice is compatible with (indeed, is necessary for) economic growth.

Once the various arguments for industrial policy are brought into the open, individuals can decide on the type of resource adjustment mechanism they prefer, in full knowledge of the consequences of each. Thus, it is clear that the industrial policy debate is really a debate about the future direction of the U.S. economy. It is a question of whether we want more direction from the center—from

[8]See Hayek (1944, chap. 10) and Friedman (1962, chap. 1).

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government, business, and labor—and greater politicization of economic life, or whether we want consumers to direct the economy via their free choices in the marketplace.

The papers in this volume discuss the above issues in detail. Kirzner's paper discusses what he calls the "basic knowledge problem"—"an individual's simple ignorance of the circumstances relevant to his situation"—and shows why this problem has important implications for both central economic planning and industrial policy. He emphasizes the key role profits play in stimulating the entrepreneur to overcome the basic knowledge problem, and shows that government planning—whether comprehensive or more limited—interferes with the "entrepreneurial discovery process." As such, government planning makes it more difficult to deal successfully with the basic knowledge problem. Current proponents of industrial policy, however, seem blissfully ignorant of this problem.

Lavoie draws on the lessons learned from the earlier debates on the possibility of rational economic calculation under socialism to critique the industrial policy proposals of Reich and Rohatyn. He cites both the knowledge problem and the political problem confronting planners; that is, the difficulty of centralizing the information necessary for allocating resources in line with consumers' preferences and the threat to a free society that arises from concentrating economic decision making in a tripartite council or planning board. Lavoie provides an interesting critique of New York City's Municipal Assistance Corporation ("Big MAC"), which Rohatyn uses as an illustration of successful investment planning, and dispells Reich's claim that Japan's Ministry of International Trade and Industry (MITI) provides us with a useful blueprint for planning U.S. economic growth.

DiLorenzo, in commenting on current industrial policy proposals, uses the theory of public choice to derive the implications of substituting bureaucratic decision making for competitive markets. He draws on historical episodes of activist industrial policy (especially the RFC experience) to illustrate the adverse effects of market interventions. He also disproves the notion that the market process is necessarily conflictual while the political process is cooperative. Vieira's paper discusses the impact current industrial policy proposals would have on economic liberties, and explains how constitutional chaos might result if cooperativist proposals were implemented. The consequences of imposing discretionary authority on the market order and disregarding the rule of law are thoroughly discussed here as well.

Pejovich shows that changes in the system of ownership rights and contractual rights affect the incentive to innovate and hence,

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economic development. He emphasizes the importance of private property rights and freedom of contract for economic development and argues that true economic development—in line with consumers' sovereignty—is characterized by *voluntary* innovation. Under the Yugoslav system of market socialism, in which no one can acquire private property rights to the flow of innovation but workers have claims to the increased net income from successful innovation as long as they remain employed with their firm, Pejovich finds a stronger incentive to innovate relative to that found in Soviet bloc economies. However, the incentive to innovate in Yugoslav firms will be weaker than that found in private, for-profit firms in the West.

Bartlett draws on economic theory and historical evidence to counter the claim of industrial policy proponents that technological unemployment is a serious problem in a growing economy. According to Bartlett, technological progress, innovation, and capital formation—or anything that increases labor productivity—can only benefit workers in the long run. Because as productivity increases so will real wages and job opportunities. Thus, under private enterprise, Bartlett finds innovation to be job-creating rather than job-destroying.

Brada discusses the experience with industrial policy in Hungary as the economic system moved from Soviet-style central planning in the 1950s to a more decentralized, market-oriented system after the New Economic Mechanism (NEM) was introduced in 1968. In recent years, Hungarian planners have been able to target sectors for development, but the lack of overall success in Hungarian development policy must be attributed to the problems Pejovich discusses in his paper; namely, the lack of private property in the means of production and the limitations on freedom of contract. Without real capital markets, the discipline of bankruptcy and the rewards for successful risk-taking will be absent or greatly reduced; entrepreneurs will then have a weaker incentive to innovate.[9] Brada recognizes the incentive problem in Hungarian enterprises, but also mentions the following sources of inefficiency: the rigidity that is introduced into the economic system by centralized investment and economic planning; the politicization of economic decision making in Hungarian enterprises; the rent-seeking activity that characterizes Hungarian industrial policy; and the inflationary bias in the Hungarian system. On this last point, Brada mentions that Hungarian officials have been reluctant to redistribute investment funds from less productive to more productive enterprises. Instead, the government has financed new investment by creating new money, thus fueling inflation. Brada

[9]For an interesting discussion of this point, see Nutter (1983, chap. 13).

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also notes that Hungarian industrial policy has been successful only to the extent it encouraged production of products for which it has a comparative cost advantage. But this is precisely the function of the competitive market process. These are all important lessons for industrial policy advocates in the West.

Sakoh presents a case study of Japanese post-World War II economic growth and addresses four questions: (1) What was the role of the Japanese government in the period of rapid economic growth? (2) What was the extent of targeting and its success? (3) Was investment largely guided by business-government consultation? And (4) What has been the role of the market in the postwar "economic miracle"? He finds that there was a minimum of government intervention; that the high-growth manufacturing sector was not targeted; that private investment provided the bulk of funds for financing economic growth; that private entrepreneurs not government officials made the key investment decisions; and that Japanese economic success can be attributed primarily to a political and economic environment that placed a greater emphasis on individual initiative and market forces. It was the breaking of barriers to social and economic mobility, the low tax rates on capital, the small and balanced budgets, the low rate of inflation, and low interest rates that helped provide the favorable climate for economic growth in postwar Japan. Sakoh concludes that "Japan's success has been in spite of, rather than because of, government tinkering." His paper dispels the myth, therefore, that Japan's economic growth can be attributed to targeting and better government planning.

The papers by Kendrick, Albertine, Niskanen, and Miller consider the problem of lagging productivity growth in key sectors of the U.S. economy and ask how America's competitiveness can be enhanced. Kendrick points out the difficulty of establishing a coherent U.S. industrial policy given the wide variation in the growth of productivity among industries. Some industries will always fall below the economy-wide average productivity growth and others will exceed that average. No one is knowledgeable enough to predict which firms and industries will be above and which below the national average at any point in time. And even if this knowledge were available, no one would know why some industries were advancing and others lagging because the causes of economic growth and decline are too complex. Thus, it makes little sense to try to promote high-growth industries or to target ailing industries. Instead, Kendrick recommends that policymakers concern themselves with establishing a stable framework for the efficient operation of the market process,

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which is a proven mechanism for picking winners and disciplining losers.

Albertine advocates breaking the tax and regulatory barriers to U.S. economic growth. He would lower the cost of capital and increase the efficiency of investment by removing the double taxation of corporate income, lowering the capital gains tax, and ultimately abolishing the corporate income tax. He also would undertake regulatory reform and revamp U.S. trade policy to allow smaller, innovative enterprises to compete more successfully in the international marketplace. Niskanen advocates a supply-side industrial policy that would provide for a stable monetary and fiscal policy environment, less regulation, fewer trade barriers, and more secure private property rights so that entrepreneurial talent could be fully utilized for the benefit of consumers.

Miller's paper questions the merits of having an activist industrial policy that attempts to achieve consensus for economic development via tripartite councils. Such a policy ignores the fact that innovation and economic progress require a departure from the status quo. The benefit of the market system is that it rewards those risk-taking entrepreneurs who break with tradition and discover new production methods, and who introduce new and better products to satisfy consumers' preferences at lower opportunity costs than heretofore. Innovation requires foresight; and the profit motive of the market—not the consensus of a tripartite council—would provide the incentive to innovate. Miller thinks the idea of consensus in government-business-labor decision making is overplayed. Given the existing institutional arrangement, the tripartite council would find it very difficult to reach a consensus on development policy. Thus, Miller argues that the consensus claimed by proponents of an activist/cooperativist industrial policy is an illusion. He sees the free-market process as the best way to utilize scarce knowledge and spur economic growth. Finally, he contends that U.S. economic performance has not been as dismal as the critics claim, and that advocates of industrial policy have neither good economic arguments nor good political arguments to buttress their claims against the market.

These papers and the comments by Hurwicz, Roberts, Horvath, Trezise, Rabushka, Milenkovitch, McKenzie, and Yeager are a valuable contribution to the discussion of the key issues surrounding the industrial policy debate and pave the way for further research.

Whether we agree that what lies behind the recent proposals for activist industrial policy is "nothing more sinister than sheer intellectual muddle," or whether we see these proposals as means to override the market process with a political process designed to

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achieve social justice, will be determined, in part, by how carefully we analyze the effects of alternative institutional arrangements on economic development.[10] The papers in this volume will assist this process, since they will improve our understanding of the role of property rights in shaping incentives and behavior. We will see that what often appears an innocent proposal turns out to have adverse and unintended consequences for resource allocation and consumers' sovereignty. In the words of Justice Brandeis:

> Experience should teach us to be most on our guard to protect liberty when the government's purposes are beneficial. Men born to freedom are naturally alert to repel invasion of their liberty by evil-minded rulers. The greater dangers to liberty lurk in insidious encroachment by men of zeal, well-meaning but without understanding.[11]

This is sound advice, well worth bearing in mind while considering the effects of government involvement in industry—or any other sector.

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[10]After reading accounts of the evolution of the Balanced Growth and Economic Planning Act of 1975, Hayek concluded, "one feels reassured that nothing more sinister than sheer intellectual muddle is at work" (1978, p. 246). While this may be true of the current efforts for a coherent industrial policy, it is also plausible that more "sinister" motives are at work; namely, motives to redistribute income and property to achieve "social justice." Nevertheless, the "intellectual muddle" argument should not be dismissed. As Buchanan (1983) has emphasized, knowledge of the market process and its institutional requirements is sorely missing from academic training. The low level of understanding of the role of prices and profits, and private property rights in generating an efficient allocation of resources in line with consumers' preferences is certainly evident in the arguments used by proponents of an activist/cooperativist industrial policy.

[11]Olmstead v. United States, 277 U.S. 479 (1928).

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A "SUPPLY-SIDE" INDUSTRIAL POLICY

William A. Niskanen

Introduction

The American debate on industrial policy was first provoked by Hamilton's *Report on Manufactures* in 1791. At that time the debate focused on whether the federal government had the constitutional authority to grant the recommended bounties to manufacturers. Hamilton argued that Congress had the power to pronounce upon the objects that concern the general welfare and that these objects extended to "the general interests of learning, of agriculture, of manufacturing, and of commerce." Madison responded sharply that "The Federal Government had been hitherto limited to the specified powers, by the greatest champions for latitude in expounding those powers. If not only the means, but the objects are unlimited, the parchment had better be thrown into the fire at once."

Our subsequent history indicates that Hamilton lost this battle but won the war. The *Report on Manufactures* was shelved. Hamilton then set up a private firm to promote the emerging technologies of that time; that firm went broke. But the same issue was later resolved in favor of Hamilton's argument, when it was determined that Congress could set higher tariffs on specific goods to promote selected manufacturing industries. The progressive erosion of the limits of the enumerated powers is one of the more serious problems of our democracy. The saddest comment on the recent debate on industrial policy is that this fundamental constitutional issue is no longer raised.

For the moment I will not join the bipartisan chorus of economists in criticizing the most recent proposals for a national industrial policy. My views on this issue are summarized in the 1984 *Economic Report*. My present purpose, in contrast, is to outline the elements

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of what might be called a "supply-side" industrial policy, something that a contemporary Jefferson or Madison might propose if either had gained the presidency following a period of extensive intervention by the federal government in the allocation of resources. The first focus of their attention, I suggest, would be on those existing interventions that are part of the problem. The second focus would be to exercise the clearly enumerated powers of the federal government to promote the general welfare. Jefferson interpreted the Constitution to limit the federal government to the "external and mutual relations only of these states." It may be too late to restore that halcyon condition, but it is appropriate to evaluate changes in policy by that high standard.

The Elements of a "Supply-Side" Industrial Policy

In a brief discussion, of course, I can only summarize the elements of a "supply-side" industrial policy. More information will be supplied on request, at least after the election.

Monetary Policy

Many of the problems cited in support of an industrial policy are macroeconomic problems. A resolution of these problems requires changes in macroeconomic policies, not increased sectoral interventions.

The conduct of monetary policy in the United States has been characterized by two biases: Monetary policy has been procyclical and, during the last 50 years, it has been inflationary. Both of these biases are especially damaging to the manufacturing industries. Cyclical variations have reduced the average capacity utilization rate and the debt share of total capital. And inflation has increased the effective tax rate on the income from capital, because depreciation allowances are not indexed. The Constitution grants Congress the clear authority "To coin money [and] regulate the value thereof . . . ." Maybe it is time for Congress to set a feasible standard for the conduct of monetary policy and to hold the Federal Reserve Board accountable to meet this standard.

Fiscal Policy

The federal budget provides substantial subsidies—in the form of grants, loans, and differential tax treatment—to the agriculture, energy, housing, medical care, and transportation sectors. Since the large relative support of these sectors diverts resources from other uses, the aggregate manufacturing sector should be regarded as a

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negatively targeted sector. Selected manufacturing industries receive some support only as a by-product of defense and space procurement and of export subsidies. In addition the large federal deficit reduces both the demand for capital goods and investment in all industries.

An activist industrial policy, as advocated by Hamilton's heirs, would grant manufacturing firms their own place at the trough, by providing subsidized loans to politically favored manufacturing firms and, presumably, by increasing the deficit by the same amount. A more attractive alternative, I suggest, is to reduce both the present bias against manufacturing and the deficit by reducing the subsidies to the other sectors, relying on the market to reallocate the available resources.

The deficit is a serious problem and it must be reduced. The primary economic consequence of the deficit is a reduction of U.S. investment, both here and abroad. For that reason it would be particularly counterproductive if the necessary deficit reduction package included an increase in the taxation of business investment. A "balance-down" strategy, followed by a progressive reduction of the remaining tax biases against business investment, is a more effective way to increase the capital stock in the manufacturing sector. Among the tax measures that should be considered are to move to an expensing standard for all business investment and to change the tax credit on incremental R&D expenditures to a lower credit based on expenditures above some fixed base.

Regulatory Policy

American industry is faced by a very complex set of laws and regulations that restrict its competitiveness. These laws and regulations serve other purposes, but the increasing concern about the competitiveness of American industry suggests that they may not reflect the desired balance of interests. In some cases the problem is due to a failure to exercise the clear responsibility of the federal government regarding patents and copyrights.

Our antitrust laws merit a thorough review. In many cases these laws are based on a premise that high concentration is associated with high prices, a premise that is not consistent with the accumulating evidence. In some cases the enforcement of these laws has had the effect of protecting weak competitors at the expense of effective competition. More attention should be given to the role of product substitution, foreign supply, and general excess capacity in disciplining potential monopoly behavior.

The administration has undertaken a number of steps to address these issues. Recent legislation now allows banks to organize export

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trading companies, and it exempts these companies from antitrust actions initiated by the government. A bill now before Congress would exempt joint ventures for R&D from treble damage suits, where such ventures comply with certain disclosure provisions. A review of the 1982 Merger Guidelines, reflecting the above concerns, is scheduled to be completed in June.

Several laws that restrict the relation between financial institutions and nonfinancial firms should also be reviewed. In the United States, almost alone among the major industrial nations, banks may not own equity in nonfinancial firms, a restriction that dates from a court ruling in 1865 based on the National Banking Act of 1864. The resulting arms-length relation between banks and nonfinancial firms has a number of adverse consequences. This restriction may have contributed to the lower debt share of the total capital of U.S. firms. And U.S. banks are precluded from serving the role of the informed representative of outside stockholders, a role that is critical to discipine the incumbent management of nonfinancial firms. Bank regulators have reason to be concerned about the overall portfolio of individual banks, but their concerns need not preclude some bank ownership of equity.

Another obscure law, dating from 1940, prohibits pension plan sponsors from structuring a compensation arrangement with plan managers that is a function of the performance of the plan portfolio. This law effectively prevents plan managers from serving as an effective discipline on incumbent management, even though pension plans now own about $700 billion of corporate assets. The Securities and Exchange Commission will soon issue a new ruling that relaxes this restraint to some degree.

These and other laws have increased the security of corporate managers at the expense of the stockholder and the competitiveness of American industry. A rising concern about the more dramatic recent takeover efforts may lead to new regulations that would only exacerbate this problem. Some effort is needed to explain that the threat of takeover, however uncomfortable to incumbent managers, is an important part of the market process that induces corporate management to serve the interests of the larger community.

The array of health, safety, environment, and energy laws and regulations approved during the last 20 years also deserves review. These laws serve important public purposes, but the explicit zero-risk standards in some of these laws prevent any meaningful balance of the several affected interests. I am intrigued to understand how the several candidates for President Reagan's job would resolve their strong commitment to both clean air and smokestack industries, but

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that is not a sufficient cause for giving them that opportunity. Someday soon, I hope, there will be a basis for discussing these issues without the rhetoric of a holy war.

Foreign Trade

The recent trend of increasing trade restraints is also discouraging. Such restraints clearly reduce our national income, by restricting a sorting out of American industry on the basis of comparative advantage. In some cases, where relatively high-paid workers are protected, these restraints reduce total employment in the short run. This problem will not be resolved by legitimizing new trade restraints in the name of facilitating adjustment. The historical record of these restraints is that they are more likely to delay, rather than to smooth, adjustment to market conditions.

What is the alternative to accepting the present and probable future increase in the protection of specific industries? Experience since the Kennedy Round suggests the answer. Average tariffs were progressively reduced only because these tariff changes were automatic, gradual, comprehensive, and mutual. In recent years these automatic reductions in tariffs were more than offset by the selective extension of other restraints. The implication of this development is that average effective tariffs are likely to increase unless some new automatic and general process of reduction in trade restraints is approved. Measures that are now being considered by the administration include an acceleration of the remaining tariff reductions under the Tokyo Round, the establishment of free trade zones with selected nations, and a new trade round focused on the major types of nontariff barriers.

Property Rights

Finally, market forces will not work effectively without well-defined property rights. Patents and copyrights are an important form of property rights, particularly in the high-technology fields that are a prime concern of industrial policy. Many people have argued that patent limitations have deterred investment in certain fields of high technology and have allowed foreign competitors to appropriate some benefits of domestic innovation. In particular, historical principles of patent and copyright law have limited the protections that could be provided to computer programs, semiconductor chip designs, and other embodiments of modern technology. Moreover, anomalies in the patent law have weakened the right of U.S. patent holders to restrict the importation and sale of products that are made abroad through patent-infringing processes.

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Some progress has been made. Computer programs have been subject to copyright since 1980. Several bills now before Congress would address these issues. One would provide copyright-like protection to semiconductor chip design, another bill would prevent the importation of goods produced abroad by patent-infringing production processes, and a third bill would permit the private patenting of technologies that were developed in part under government contract. The administration has substantially improved the patent review process and is studying the general set of intellectual property laws to identify other ways by which such property rights may be extended and strengthened. Congress should now address these issues to fulfill its constitutional responsibility "To promote the Progress of Science and [the] Useful Arts . . . ."

Conclusion

The nation is now faced by a choice between two industrial policies. One policy perceives government intervention as part of the solution, the other as part of the problem. One would substitute the judgment of politicians and bureaucrats for that of private investors; the other would extend and strengthen market processes. One would sustain the progressive erosion of the enumerated powers; the other would build on the clear constitutional responsibilities of the federal government. I welcome the national debate on this issue. My choice should be clear.

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U.S. ECONOMIC POLICY AND PRODUCTIVITY GROWTH

John W. Kendrick

Introduction

Throughout most of American history, main reliance for increasing productivity has been placed on the workings of competitive markets in our predominantly free, private enterprise economy. The logic is well known. Offensively to widen profit margins, or to defend them from encroachment by competitors, company managements reduce costs by increasing efficiency under given technology or by technological or organizational innovations, and/or introduction of new products, including more efficient producers goods. Real unit cost reduction is, of course, the opposite side of the productivity coin. Temporarily abnormal profits are considered a socially desirable incentive and reward for successful innovations. But pro-competition policies, outside of regulated natural monopolies, are considered necessary to ensure that abnormal profits are competed away to the benefit of consumers. The only way that firms can continue to earn above-average rates of return under competition is by continuing to stay ahead of the pack technologically. Since this is not easy to do, technological leadership has tended to rotate among the firms of industries, and among the various industries.

With respect to the relative industry rates of growth of productivity, real product, and employment, again main reliance has been placed on the allocative functions of markets for goods and for the factors of production. Certainly in the past, governmental measures, consciously or not, have affected different industries differently, or have been targeted on particular industries. But there has not been a systematic, centrally planned industrial policy, apart from a few episodes of wage and price controls and wartime allocations. Investments to replace and expand capacity and to reduce costs, by the

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firms in the various industries generally have been determined by economic criteria; that is, carried to the point where the expected rates of return equal the marginal cost of funds. Reflecting competitive market forces and dynamic changes in supply and demand conditions, there has been a fairly wide dispersion among industries in rates of change in productivity, output, and employment, and considerable variability in those changes. Predictably there have been periodic cries for protection and assistance from the firms and/or industries whose fortunes are at least temporarily on the downgrade. Their causes have been succored by the economists and politicians who call for a comprehensive industrial policy. There are others who, in view of the productivity slowdown of the past decade, call for a strong federally funded national productivity organization to plan policies to accelerate productivity growth generally.

My own view is that a federal government productivity organization is unnecessary, and that a formal apparatus to design and execute "industrial policy" would reduce, rather that enhance, the growth of overall productivity and economic welfare. I shall now elaborate somewhat on each of these two points.

National Productivity Policy

The traditional approach to growth of productivity and real gross product worked quite well over most of the past century. As shown in Table 1, total factor productivity in the U.S. business economy, which had grown at an average annual rate of less than 0.5 percent for most of the 19th century, accelerated sharply after 1889 and again after World War I to better than 2 percent through 1966. Real product per labor hour accelerated to better than 3 percent a year during the golden era of the first two post–World War II decades. Even the earlier 2.0 percent average annual rate of increase in real income per capita meant a tripling between the 1890s and 1948. During the golden era U.S. levels of productivity and real income per capita were the highest in the world.

The Marshall Plan aid program required the establishment of productivity centers in recipient countries to help diffuse new technology as part of the reconstruction and development effort. By the late 1950s most major countries of the world outside the United States had productivity centers and were beginning to outstrip the United States in productivity gains.

When, by 1970, it became apparent that U.S. productivity growth had slowed significantly in the late 1960s, associated with accelerating inflation, it is not surprising that President Nixon established a

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TABLE 1

REAL GROSS PRODUCT, FACTOR INPUTS, AND PRODUCTIVITY RATIOS
U.S. DOMESTIC BUSINESS ECONOMY, SELECTED PERIODS, 1800–1981
(Average Annual Percentage Rates of Change)

	1800–1855	1855–1890	1889–1919	1919–1948	1948–1973	1973–1981
Real Gross Product	4.2	4.0	3.9	3.0	3.7	2.2
Population	3.1	2.4	1.8	1.2	1.5	0.8
Real Product per Capita	1.1	1.6	2.1	1.8	2.2	1.4
Total Factor Input	3.9	3.6	2.2	0.8	1.7	2.0
Labor	3.7	2.8	1.8	0.6	0.7	1.4
Capital	4.3	4.6	3.1	1.2	3.6	3.2
Productivity Ratios: Total	0.3	0.3	1.7	2.2	2.0	0.1
Labor	0.5	1.1	2.0	2.4	3.0	0.8
Capital	−0.1	−0.6	0.7	1.6	0.1	−1.0

SOURCES: 1800–1948, Kendrick (1979); 1948–1981, Bureau of Labor Statistics, U.S. Department of Labor.

National Commission on Productivity (NCOP) in July 1970 to develop policies to promote productivity growth and related activities. The motivation was strengthened by the accumulation of statistics indicating that most other advanced economies, and many of the less-developed ones, were surpassing the productivity growth of the United States by considerable margins and providing sharper competition in international markets for an increasing number of commodities.

Consideration was not given to the fact that over longer periods of time, periods of strong growth in productivity and real GNP had been succeeded by periods of slower growth. Simon Kuznets (1961, esp. chaps. 7–8) called these alternating periods "long swings" in economic activity, noting that their average duration was 15 to 20 years. Actually growth resumed quite well in the 1970–73 subperiod, only to be succeeded by the pronounced slowdown from 1973 to 1981.

It was not recognized that the relatively low standing of the United States in international comparisons of productivity growth rates was not an indictment of U.S. performance, but rather a tribute to the rapidity with which other nations were catching up technologically, due in part to our own foreign economic policies. To some degree superior productivity growth abroad was due to higher rates of saving and investment, reflecting more favorable tax treatment. But the cure for this discrepancy was not a productivity commission, but rather a more enlightened tax policy from Washington (see Kendrick 1982).

Eight years later after the creation of the NCOP, its successor organization established by Congress in 1975, the National Center for Productivity and Quality of Working Life, was allowed to expire. By then there was wide agreement with the conclusions of a Government Accounting Office report to Congress (23 May 1978) that the center had not achieved its objectives. For one thing the rate of productivity growth decelerated even more sharply after 1973 than in the late 1960s. Part of the deceleration was due to factors beyond the scope of policy levers—acceleration in labor force, growth, changes in its mix that resulted in reduced average experience of workers, and less favorable shifts in the composition of output. But much of it was a result of failed or faulty macroeconomic policies, responsibility for which resided in other government agencies. Causal factors of this sort that have been identified by students of the slowdown (for example, Kendrick 1979) were: the acceleration of inflation, exacerbated by the oil shocks, that eroded real profit margins, increased the income tax burden, and discouraged saving; unfavorable tax measures that reduced the rate of growth of real capital; a declining ratio of research and development (R&D) to GNP; declining quality of education; and increased regulatory burdens, part of which

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represented a conscious trade-off of productivity growth against social objectives.

Already in the latter part of the Carter administration, and after the election of Reagan, a consensus was developing on the need to create a more favorable climate for saving, investment, and productivity growth.[1] Working through the normal economic policy-making apparatus, measures were taken beginning in 1978—notably the reduction of capital gains tax rates; real increases in federal government funding of R&D; reductions in economic regulations and increased rationalization of social regulations; the ERTA reductions in income tax rates, the accelerated cost recovery system, and the 25 percent incremental R&D tax credit. All of these, I believe, together with positive demographic developments, should result in a stronger productivity trend for the rest of this decade (which, incidentally, would accord with Kuznets' long-swing chronology).

The more specific functions of the national productivity center could be and were transferred to the agencies with primary responsibility in those areas; that is, promoting productivity improvements in government went to the Office of Personnel Management; facilitating labor-management cooperation to promote productivity to the Department of Labor and the Federal Mediation and Conciliation Services; and promoting scientific and technological advances to the National Science Foundation and the Department of Commerce. The role of management education and consulting was much less necessary in the United States than it was abroad, in view of the many schools of engineering and business administration here, and the plethora of consulting firms and state and local private, nonprofit productivity centers.

In his report, the comptroller general noted the need for a mechanism to coordinate and integrate all federal policies and programs related to productivity. To serve this function he recommended the creation of a National Productivity Council composed of representatives of agencies having productivity-related missions, and linked to the budgetary process. This approach was tried in the final months of the Carter administration but abandoned by the Reagan administration.

Another possible approach would be to give responsibility for coordinating long-run economic projections and planning of policies

[1]The 1979 reports of the Joint Economic Committee were unanimous, and the committee called for "... the adoption of longer-run policies aimed at expanding the nation's productive potential in a manner that raises dramatically the growth of American productivity" (U.S. Congress 1979, p. 6).

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to promote growth of productivity and real GNP to one of the members of the Council of Economic Advisers, with adequate staff support.[2]

In concluding the macroeconomic section of this paper, I must state my own view that the most important measure for promotion of productivity will be a simplification and reform of the federal tax system to eliminate the bias of income taxes against saving and investment. Either saving could be exempt from the income tax or a tax could be placed directly on consumption expenditures or on value-added. On the expenditure side of fiscal policy, I should like to remind some of my conservative colleagues of the need for adequate public investments in infrastructure, basic research, R&D in areas related to government expenditures, education, training, and public health and safety. Possibly it would help in applying business criteria to screening public investments and in securing their funding (particularly when Congress is in a penny-pinching, pound-foolish phase) to establish a separate federal capital budget.

Industrial Policy

With regard to industrial policy, its inherent difficulties can be seen by looking at the record of growth of output and productivity by industry since 1948 (Kendrick 1983). Particular attention is focused on relative productivity growth which is negatively correlated with relative changes in prices and is thus crucial to an industry's competitive position in world trade, as well as in the domestic struggle for the consumer's dollar. In the nonfarm commodity-producing industries there is a significant negative correlation between relative changes in prices and in output (sales plus inventory change), and thus a positive correlation between relative changes in productivity and in output (Kendrick 1983, pp. 25–34).

Looking at over 30 one-digit and two-digit industry groups based on the Standard Industrial Classification (see Table 2), rates of growth in real gross product between 1948 and 1979 varied between just over and under 7 percent a year for communications and electrical machinery down to small declines for railroads and leather and leather products. For the seven subperiods, measured between business-cycle peaks, dispersion was greater, with growth rates ranging from over 15 percent to less than minus 3 percent. When industries are further decomposed into three-digit and four-digit groups, dispersion of growth rates becomes even greater.

[2]This proposal was elaborated by Kendrick (1984) in his presidential address to the Southern Economic Association.

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Dispersion in rates of change of total factor productivity during the 1948–79 period is a bit less than in output, ranging between 4.6 percent a year for communications and 0.3 percent for primary metals and 0.2 percent for services (see Table 3). During the 1973–79 subperiod, dispersion as measured by the average deviation was more than 50 percent higher than for the 1948–79 period as a whole, and extensions of the estimates through 1981 (the latest cycle peak) show the average deviation of growth rates from the minus 0.4 rate for the business economy as a whole 1979–81 to be more than double that for the 1948–79 period. If productivity is measured in terms of real product per labor hour, the rates of change are generally higher than for total productivity since capital per unit of labor input rose in all industry groups but one. Dispersion of rates of change in labor productivity was somewhat higher than in total factor productivity.[3]

The greater dispersion of growth rates in subperiods than over longer periods implies considerable variability in rates of growth. This is underlined with reference to the rankings of the 31 industry groups with respect to total factor productivity growth over the 1948–79 period, and in each of the seven subperiods (see Kendrick 1983, pp. 22–23). Communications ranked first for the 1948–79 period, but was first in only one of the subperiods and as low as 13th in another. The industry group with the greatest variability in productivity growth rates, petroleum refining, was first in the subperiod 1957–60, but 31st in 1966–69, and averaged 17th over the entire period. Even the more stable groups, such as stone, clay, and glass products, show considerable variability.

This brief historical review has a number of implications regarding the desirability of industrial policies. First, it is clear that industries differ widely in rates of growth of output and productivity, and, associated with that, in rates of growth of employment and real capital. Moreover the growth rates differ widely across subperiods. This dispersion and variability would obviously make it difficult to forecast such key policy variables as investment, hiring, training, procurement, and other variables requiring considerable lead time.

By definition, and as exhibited in the tables, there are always industries whose productivity rates are less than average. It is the weaker firms in those industries that are most apt to experience difficulties in competing both at home and abroad. Their plight, of course, is accentuated when productivity in the entire business economy slows down absolutely and relative to that in other nations.

[3]Rates of change in labor productivity for three-digit and four-digit industries are presented in Kendrick (1983, pp. 60–65).

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TABLE 2

RATES OF CHANGE IN OUTPUT (REAL GROSS PRODUCT), U.S. BUSINESS ECONOMY, BY INDUSTRY GROUP, 1948–1979
(Percent)

	1948–1979	1948–1953	1953–1957	1957–1960	1960–1966	1966–1969	1969–1973	1973–1979	Average Deviation
Private Business Economy	3.5	4.1	2.4	2.1	4.9	3.4	3.8	2.5	0.8
Manufacturing	3.6	5.8	1.0	0.8	6.3	2.8	4.1	2.1	1.9
Food	2.7	3.4	2.3	1.3	3.9	1.4	5.5	0.6	1.4
Tobacco	2.1	1.8	2.5	5.3	0.9	2.1	3.7	0.6	1.2
Textiles	3.2	−0.6	1.1	1.3	9.6	1.5	5.3	2.0	2.7
Apparel	3.0	3.4	0.4	2.6	4.9	0.8	5.3	2.4	1.5
Lumber	2.7	−2.2	1.4	0.9	8.1	1.8	6.0	1.8	2.6
Furniture	3.2	3.2	1.7	0.9	5.9	2.8	2.7	3.0	1.1
Paper	4.1	6.2	1.9	3.8	5.2	5.8	5.6	1.2	1.7
Printing	3.0	2.8	4.2	2.4	5.2	3.1	1.9	1.0	1.1
Chemicals	6.1	6.2	7.4	4.5	8.0	6.6	6.5	3.7	1.2
Petroleum	3.6	4.9	2.5	5.8	4.1	−0.6	8.3	0.7	2.4
Rubber	5.1	5.9	−0.6	6.6	9.1	7.8	6.0	1.8	2.7
Leather	−0.2	−2.5	−1.2	1.4	4.0	−3.2	0.3	−1.1	1.9
Stone, Clay, Glass	2.8	4.0	1.8	2.6	4.1	2.4	3.8	0.6	1.0
Primary Metals	1.1	5.3	−1.1	−6.3	6.1	−1.6	2.9	−1.7	3.7
Fabricated Metals	3.5	7.0	0.4	0.5	6.6	4.5	1.8	1.7	2.5
Nonelectrical Machinery	3.7	5.6	−1.1	−0.6	8.1	1.7	4.4	3.8	2.6

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Electrical Machinery	6.8	11.1	2.1	5.8	11.2	5.9	3.6	5.0	2.9
Transportation Equipment	4.8	15.4	−0.2	−2.1	8.8	2.6	2.8	1.9	4.8
Instruments	6.0	11.8	1.8	4.8	7.6	6.7	3.1	4.9	2.5
Miscellaneous Manufacturing	3.1	2.6	1.3	2.6	4.3	4.3	4.4	2.1	1.1
Nonfarm Nonmanufacturing	3.6	3.5	3.2	3.2	4.4	3.7	3.8	3.0	0.4
Mining	2.0	1.6	3.2	−0.9	3.5	3.3	1.3	1.5	1.2
Construction	2.6	5.6	4.1	4.0	2.9	0.7	1.9	−0.5	1.7
Rail Transportation	−0.2	−1.1	−0.9	−2.8	4.5	−1.5	−2.8	0.4	1.9
Nonrail Transportation	2.8	−0.8	2.4	0.9	5.0	4.4	4.6	3.0	1.7
Communications	7.3	7.2	6.2	5.6	7.3	8.8	7.6	7.8	0.7
Public Utilities	5.9	9.7	7.2	6.8	5.5	7.0	4.5	2.4	1.8
Trade	3.8	3.8	3.6	2.8	4.9	3.6	5.0	2.7	0.7
Finance, Insurance	4.1	4.9	5.4	2.9	3.4	6.3	3.3	3.4	1.1
Real Estate	3.1	2.9	2.5	3.7	3.9	2.2	3.0	3.1	0.5
Services	3.6	3.1	1.7	4.4	4.6	4.3	3.0	3.9	0.8
Farming	1.1	1.2	0.3	1.4	−0.4	1.7	2.0	2.0	0.7
Average Deviation	1.3	3.0	1.7	2.3	2.8	2.7	2.3	2.0	

SOURCE: Kendrick (1983, pp. 10–11).

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TABLE 3

AVERAGE ANNUAL RATES OF CHANGE IN TOTAL FACTOR PRODUCTIVITY, U.S. PRIVATE BUSINESS ECONOMY, BY MAJOR INDUSTRY GROUP, 1948–1981
(Percent)

Industrial Sector	1948–79	1948–66	1966–73	1973–79	1979–81
Private Business Economy	2.0	2.6	1.7	0.4	−0.4
Manufacturing	2.2	2.5	2.4	0.8	−0.4
Food and Kindred Products	2.7	3.0	4.1	−0.0	4.5
Tobacco	1.9	2.1	2.5	0.3	−7.0
Textiles	3.6	3.9	2.8	3.7	−0.9
Apparel	2.6	2.1	2.8	3.9	1.2
Lumber	2.8	4.0	2.0	0.1	−2.9
Furniture	2.0	2.0	1.0	3.3	1.4
Paper	2.3	2.2	4.4	0.0	−2.8
Printing and Publishing	1.4	2.4	0.9	−1.1	1.5
Chemicals	3.4	3.7	4.7	1.2	−1.2
Petroleum	1.9	3.2	2.3	−2.4	−8.0
Rubber	1.7	2.2	2.2	−0.5	−0.2
Leather	1.3	1.0	2.1	1.2	−0.7
Stone, Clay, and Glass	1.4	1.8	1.3	0.1	0.6
Primary Metals	0.3	1.0	0.6	−2.0	−2.7
Fabricated Metals	1.4	1.6	1.3	0.7	−0.4
Nonelectrical Machinery	1.3	1.4	1.6	0.8	1.3

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Electrical Machinery	3.7	4.1	3.2	3.3	1.0
Transportation Equipment	2.5	3.2	2.7	0.3	−4.9
Instruments	2.7	3.5	2.3	0.9	0.5
Miscellaneous Manufacturing	2.5	2.2	4.0	1.9	2.7
Nonfarm Nonmanufacturing	1.3	1.9	1.0	0.1	−0.5
Mining	0.9	2.4	1.4	−4.0	−1.4
Construction	0.5	2.2	−0.8	−3.0	−2.5
Rail Transportation	2.9	4.4	0.3	1.3	1.8
Nonrail Transportation	1.1	0.8	2.4	0.9	−1.2
Communications	4.6	5.3	3.2	4.3	4.0
Public Utilities	3.2	5.4	1.2	−0.9	−2.2
Trade	2.1	2.5	2.4	0.6	−0.7
Finance, Insurance	0.5	1.1	0.3	−0.9	−1.3
Real Estate	1.3	1.8	−0.0	1.2	−1.0
Services	0.2	0.4	−0.3	0.1	1.0
Farming	3.5	3.9	3.5	2.2	3.7
Unweighted Average	2.1	2.6	2.0	0.6	−0.5
Average Deviation	0.9	1.0	1.2	1.4	2.1

SOURCE: Kendrick (1983, p. 24).

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Thus, during the 1973–79 subperiod, 9 of the 31 industry groups showed absolute declines in total factor productivity, and when overall productivity dropped by 0.4 percent a year during the 1979–81 subperiod, 18 of the groups showed decline. For example transportation equipment (which includes automobiles) had an average 4.9 percent a year decline, and primary metals (mainly iron and steel) had a 2.7 percent a year decline from 1979 to 1981—industries that have been most vociferous in seeking protection and assistance.

Another bad year for U.S. business interests was 1982. Real business product declined by almost 3 percent, and productivity sagged a little further. The crunch on industries competing in international markets was accentuated by the appreciation in the foreign-exchange value of the dollar through 1983 and the slower recovery abroad. The latter was associated with a smaller increase in U.S. exports relative to imports.

Despite international problems, 1983 was a year of reasonably robust economic recovery, with real business product up 4 percent and real product per hour improving by more than 2.5 percent.[4] With recovery continuing strong in early 1984, formerly depressed industries were hurting far less. Profits of the auto industry are very good, and even the steel industry is making a comeback.

If I am right that the rest of the 1980s will experience stronger growth than the decade ending in 1982, I would guess that there will be less talk of industrial policy, let alone bailouts.

Conclusion

It is fundamentally important for the general public to understand that there are and always will be industries that are falling below average in productivity growth and are therefore losing comparative advantage in foreign trade. It would be a never-ending task and a bottomless pit financially for the government continually to seek to strengthen those industries.

Even if it could be decided which industries should be assisted, the policies required to promote their relative productivity growth are not easy to determine. Analyses indicate the causal forces are complex (Kendrick 1983, pp. 34–50). Some of the variables positively correlated with productivity growth are scale; growth of real capital stocks per unit of labor input; ratios of R&D to sales, not only within the given industry but also in supplying industries; average education and training per worker; percentage of women in the work force;

[4]See *Economic Report of the President, 1984*, chap. 6.

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and layoff rates. Negatively correlated with relative productivity growth are cyclical amplitude of production; proportion of the work force belonging to unions; man-days idle on account of strikes; the quit rate; the rate of increase in the female proportion of the work force; and the rate of increase of concentration. Selection of the proper policy mix is made even more difficult by the differential and variable lags between the initiation of policies and their impact on productivity.

The basic point is that we are not omniscient or smart enough to pursue a systematic, centralized industrial policy that would be effective in the sense of giving better results than the market in our complex and dynamic type of economy. The important role of government is to provide a reasonably stable, favorable environment for private enterprise.

I also believe that government has a role in facilitating the transfer of resources, particularly labor, among industries and uses. The community should be willing to pay for retraining and, where necessary, the relocation of workers who are displaced, through no fault of their own, by forces that increase real income of the population generally.

What about the argument that we should replace the present patchwork of policies that have differential industry impacts by a systematic approach involving a central agency to shape federal industrial policy, multipartite industry councils, and a development bank? Certainly most industries are affected to a greater or lesser extent by many current policies in the areas of tariffs and quotas, regulation, taxation, and government outlays, including subsidies. Should these not be rationalized?

The short answer is no, not by the apparatus mentioned above for developing and executing industrial policy. It would become the fulcrum for intensive lobbying and political pressures to influence the fortunes of the various industries. Further distortions than now exist in pricing and the allocation of resources would inevitably arise. An additional virtue of the market economy would be compromised—the decentralization of decisions on innovation and the associated investments to managers of individual enterprises who know their industries better than any outside bureaucracy and who bear the penalties for faulty judgements.

In conclusion, I must express my agreement with the president's Council of Economic Advisers, who in their 1984 report stated:

> Our market economy and its system of rewards for superior performance have made the American economy the most productive and innovative in the world. An industrial policy that increases government planning, government subsidies and international

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> protectionism would only be a burden on our economic life and a threat to our long-term economic prosperity.
>
> [*Economic Report* 1984, p. 111][5]

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[5]It is said that Chapter 3 of the Council's 1984 Annual Report, from which this passage was taken, was written by William Niskanen.

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RESTORING U.S. COMPETITIVENESS

Alvin Rabushka

Professor John Kendrick (1984) has demonstrated convincingly that reliance on private enterprise as the main vehicle to raise productivity has worked well throughout American economic history. Markets successfully allocate factors of production to industries. As one might expect, there has been historically wide dispersion among industries and variability across subperiods.

Productivity growth turned sour in the late 1960s compared with our European and Asian trading partners, due largely to increasingly unfavorable tax treatment accorded savings and investment in the United States. The American slowdown is traceable to faulty macroeconomic policies: inflation, increased income tax burdens, taxes on capital, the declining quality of education, and increased governmental regulation. Thus for Kendrick, government has been the cause of declining productivity, not the potential cure.

Beginning with the 1978 reduction in the capital gains tax rate, and continuing with the 1981 Economic Recovery Tax Act's across-the-board marginal tax rate reductions, the federal government has begun to recognize the deleterious consequences for productivity growth of punitively high rates of taxation. Building on that experience, Professor Kendrick suggests that future tax reform exempt savings, that we in fact adopt a consumption tax to stimulate greater savings and investment, a suggestion with which I entirely agree. Before building on his analysis of the need for substantial reform of our macroeconomic policies, I would like to raise two minor points of disagreement.

First, I oppose a publicly provided program to retrain and relocate workers. No matter how sound the idea, the Congress and bureaucracy, supported by numerous political and economic interests, would politicize the implementation of any such program. In short order a

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job retraining and relocation program would resemble the countercyclical public jobs programs, which most economists claim do more economic harm than good. Second, the suggestion to separate the federal capital and current account budgets is another good idea in principle, but which also founders on the shoals of political implementation. The legal structure of government financial accounts is unlikely to alter the incentives that members of the executive and legislature branches have to increase spending.

On all other counts I fully endorse Professor Kendrick's interpretation of U.S. productivity growth and decline. The solution to declining productivity lies not in centralizing the current hodgepodge of ad hoc regulatory and tax policies, which would be tantamount to pouring gasoline on a raging fire, but rather in restoring the maximum degree of national reliance on market forces, which has proven the best tonic for fostering sustained growth, steadily rising living standards, and economic freedom and opportunity in the process of sustaining individual liberty.

Professor Kendrick's focus on faulty macroeconomic policies as the cause of declining productivity is an invitation to propose a substitute set. For me the objective of macroeconomic policy is to maximize economic growth with a minimum of governmental intrusion into the private affairs of the people. Welfare economics tells us that competitive markets yield an optimal allocation of resources; they are, in short, allocatively efficient. Perfect competition yields a set of prices for inputs and outputs which places maximum valuation on every economic good. In such a market the value of any item to each consumer—how much he is prepared to pay—is exactly equal to the marginal cost to any producer—how much he must spend to produce it.

Free entry (and exit) and unregulated prices satisfy the requisites for competition. No one buyer or seller can be dominant enough in the market to set prices. Nor can there be any legal or arbitrary barriers to access. Resources must be free to move to their most highly valued use. In a competitive or free-market economy the government does not interfere with the prices established by market forces; nor does it protect existing firms from the pressure of competitors. Government imposes no legal restrictions limiting market entry of buyers or sellers.

The rationale for government can arise, then, in purely economic terms when the conditions of competitive markets are not satisfied. Examples include the presence of monopolies, externalities which inflict costs that are not compensated, and the need to provide such public goods as law and order, national defense, and public works,

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because private suppliers have no practical way to charge for the benefits of their services. Most governments also provide a monetary framework and negotiate international agreements. Government has a legal monopoly on coercion, and with it the power to tax, spend, and regulate. In pursuit of maximum productivity growth, the direct cause of rising living standards, it is essential to define the legitimate scope of government action consonant with competitive markets. Thus we return to the subject of appropriate macroeconomic policies of taxation, spending, regulation, monetary policy, and international trade.

Taxation

The requirements for a sound system of taxation are that it satisfy the criteria of neutrality (not distort one form of activity in favor of another), efficiency (not produce dead-weight losses in the economy as a result of avoidance and evasion), predictability (to minimize costly adjustments to chronic changes), comprehensibility (it should not require a doctorate in accounting and tax law to complete tax forms), and fairness (meaning that taxpayers in similar circumstances should pay similar rates of tax). To this end, economists of all persuasions concur that a uniform tax rate imposed on consumption would best satisfy these conditions. By encouraging saving and investment, it would stimulate maximum rates of economic growth.

In collaboration with Professor Robert E. Hall (1983), I have developed a uniform flat-rate tax on consumption (hereafter the Hall-Rabushka flat tax). Our proposed replacement for both the current personal and corporate income taxes would raise more revenue than the current systems by broadening the tax base and lowering the top marginal rate to 19 percent. It would eliminate double taxation by integrating the corporate and personal income taxes. By placing interest on an after-tax basis, interest income would not be taxed and interest expenses would not be deductible. We replace the current hodgepodge of depreciation schedules with 100 percent expenses of all annual capital outlays (which restricts taxation to consumption), and also abolish the capital gains tax on financial assets. Moreover we have managed to condense the annual filing requirements to no more than two postcard-sized forms depending on whether one is exclusively salaried or also owns a business enterprise. Adoption of the Hall-Rabushka plan would dramatically enhance the incentives to work, save, and invest—thereby sharply increasing annual productivity growth. In the process it would eliminate billions of dollars

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in costs of direct compliance (lawyers, accountants, record keeping) and avoidance/evasion behavior (due to high marginal tax rates).

Budgetary Reform

Concern over multi-hundred billion dollar federal budget deficits has risen commensurate with a growing trend of federal fiscal irresponsibility. Collective concern by the Congress and the president for stable prices and full employment is no match for the spending incentives faced by individual members of Congress, who respond to tugs of turf and constituency in the biannual struggle for reelection. The mismatch between individual and institutional incentives calls for some structural reform to restore the Victorian norms that dictated annual balanced budgets, a limited scope for government spending, and low levels of taxation—norms that held sway in America until the combined advent of the New Deal and World War II. Deficit spending has replaced balanced budgets, and runaway government spending has destroyed limited government.

Statutory reform is inherently unsuited to accomplish the objectives of restraining public spending and restoring the norm of fiscal balance. The reason is that the adoption of a budget deficit overturns any statutory limitation on budget procedures. Therefore only a constitutional amendment can limit spending and taxation and can mandate a balanced federal budget.

Since 1975 supporters of constitutional limits on spending and deficits have persuaded 32 state legislatures to petition Congress to invoke Article V of the Constitution and call a constitutional convention to write a balanced budget amendment. In August 1982 the United States Senate approved by 69 to 31 a balanced budget/tax limitation amendment that failed to win approval in the House of Representatives. Adoption of this amendment would restore fiscal sanity, thus mirroring the first 175 years of American history during which the unwritten norms of budgetary balance and limited government prevailed. The amendment would restrain the growth rate of public spending and taxation, thus shifting resources from the inefficient public to the more efficient private sector. Pressure on the credit markets would ease as public competition with private users of credit declined. Combined with a low flat tax, the adoption of a balanced budget/tax limitation constitutional amendment would be the best corrective for today's faulty macroeconomic policies.

Other Measures

Printing of money and a monopoly on legal tender are the prerogatives of virtually every government. Private competing monies have

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been infrequent in world history. But the absence of private money is not the cause of unstable prices or inflation. Rather, governments the world over, especially the U.S. government since 1971, have shown themselves increasingly unable to maintain a regime of price stability. The proximate cause of contemporary price instability is the abolition of the Bretton Woods ("gold standard") system of international monetary policy that prevailed from the end of the Second World War until President Richard Nixon closed the "gold window" to foreign holders of dollars in 1971. By removing the last external check on domestic credit creation, the Federal Reserve Board has been able to accommodate ever-increasing credit demands by the federal government, resulting in inflationary effects and dramatic swings in the price level (and relative prices).

Without engaging in the extensive debate among monetarists, let me express a straightforward preference for a price rule (fixing the dollar price of gold at which the central bank stands ready to buy and sell gold) instead of a growth rule (stipulating a steady annual increase in some monetary indicator such as M1). My reasons are simple. A bank clerk with scale in hand can implement the price rule. Armies of discretionary central bank authorities have thus far failed to demonstrate either their commitment to a money growth rule or their ability to adhere to one suitably defined. A gold standard price rule at least guarantees the quality of money, a task government seems better able to perform than maintaining some predetermined growth rate in the quantity of money.

Last, but not least, is government regulation of both domestic and international economic activity. Unless regulatory benefits exceed costs, or some absolute, overriding social objective prevails, the consequences of regulation are declining productivity and slower rises in living standards. In the same vein the requisites of free entry and unregulated prices that characterize the competitive market economy dictate an international regime of free trade.

Conclusion

The solution to restoring higher levels of annual growth in productivity is straightforward: the restoration of the economic, fiscal, monetary, and regulatory regimes that prevailed throughout the bulk of American history.[1] These policies, in Professor Kendrick's words,

[1]For a detailed treatment of these issues, see Rabushka, *From Adam Smith to the Wealth of Nations* (1984). That book explores the economic policies of 19th-century Britain and those of the successful postwar Asian nations of Hong Kong, Taiwan, Singapore, and Korea, and it applies their lessons to contemporary America.

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would reinstate our nation's historical reliance on private enterprise to raise productivity and living standards, policies that have proved successful in our past and, when adopted, in other nations as well.

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ECONOMIC PLANNING AND THE KNOWLEDGE PROBLEM

Israel M. Kirzner

Introduction

It is now about 40 years since Professor Hayek decisively identified the key misconception underlying mainstream welfare economics. This misconception, Hayek argued, was responsible for failure to appreciate the critique of the possibility of rational economic calculation under central planning—a critique stated most forcefully and clearly by Mises, and further developed by Hayek himself. As has been demonstrated by Professor Lavoie (1985), the true import and significance of the Hayekian lesson was simply not grasped by subsequent welfare economists writing on the socialist calculation debate, even though Hayek's work was widely cited.

In this paper we attempt both to restate and to extend Hayek's insight concerning the "knowledge problem" and its implications for central economic planning, whether comprehensive in scope or otherwise. In the following paragraphs we cite Hayek's own formulation of his insight, and make certain observations concerning it. In subsequent sections of the paper we start from a rather *different* point of departure, and in this way eventually arrive at our restatement and extension of the Hayekian position—spelling out some rather radical implications of our restatement.

According to Hayek (1945, pp. 77–78):

> The peculiar character of the problem of a rational economic order is determined precisely by the fact that the knowledge of the circumstances of which we must make use never exists in concentrated or integrated form but solely as the dispersed bits of incomplete and frequently contradictory knowledge which all the separate individuals possess. The economic problem of society is thus not merely a problem of how to allocate "given" resources—if "given" is taken

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> to mean given to a single mind which deliberately solves the problem set by these "data." It is rather a problem of how to secure the best use of resources known to any of the members of society, for ends whose relative importance only these individuals know. Or, to put it briefly, it is a problem of the utilization of knowledge which is not given to anyone in its totality.

Let us call *this* knowledge problem "Hayek's knowledge problem." We note, at this initial stage in our discussion, that the position might be taken that Hayek's knowledge problem does *not*, at least at first glance, render immediately irrelevant the paramountcy of the social efficiency norm. It is true, as Hayek pointed out, that the dispersed character of knowledge means that the economic problem is not that of allocating "given" resources, where "given resources" means resources given and known to a single mind. But surely knowledge itself is a scarce resource. So that the task of the central planner may be seen, in the light of Hayek's knowledge problem, as that of making the most effective use of the available dispersed knowledge existing in society at a given moment—with the attainment of such use constrained by the communication and search costs made necessary by the dispersed character of the available information.

It might seem, therefore, that there is nothing in Hayek's knowledge problem which places it outside the scope of economic planning. The knowledge problem, it might be argued, complicates the planning task: It introduces a newly recognized, subtle, and complex resource (knowledge); it compels attention to the special characteristics of this resource (its dispersed character); and it calls for attention to a special class of costs (those required for search and communication). But Hayek's knowledge problem can still, it might seem, be subsumed under the overall economic problem, traditionally conceived in resource-allocation terms. The central theme of this paper is to deny this understanding of the implications of Hayek's knowledge problem.[1]

[1]Hayek (1979, p. 190) has more recently deepened our understanding of the problem of dispersed knowledge as going far beyond that of "utilizing information about particular concrete facts which individuals already possess." He now emphasizes the problem of using the abilities that individuals possess *to discover* relevant concrete information. This leads Hayek to point out that because a person "will discover what he knows or can find out only when faced with a problem where this will help," he may never be able to "pass on all the knowledge he commands. . . ." In recent unpublished work Professor Lavoie, building on insights contained in the work of Michael Polanyi, also has emphasized the relevance of "tacit knowledge" for the social problem of utilizing dispersed knowledge. The present paper arrives at similar conclusions but from a somewhat different starting point.

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In this paper I shall argue that this problem of securing the best use of dispersed knowledge, in fact, *cannot* be translated into a special case of the more general problem of securing an efficient allocation of society's resources. It will follow that societal planning, by its very character, is incapable of addressing Hayek's problem—such planning can only frustrate and hamper those spontaneous market forces that *are* capable of engaging this knowledge problem. In order to develop these arguments it will be useful to introduce a "knowledge problem" that at first glance seems very different from Hayek's.

The Individual Plan and the Knowledge Problem

In the course of everyday life man continually *plans*. Economists have come to formulate the individual plan as the seeking of a maximum: The planner is intent on arriving at a constrained optimum position. This is the concept of the economizing decision articulated with special precision and force by Lionel Robbins in 1932, and widely adopted since then as the basic building block of microeconomic theory. We wish to point out that there is an inescapable potential "knowledge problem" surrounding this concept of the individual plan.

The notion of the plan presupposes some deliberately aimed-at entity—say, utility, or profit—that is to be knowingly maximized. It further presupposes known resource constraints. In Robbins' terminology, both the ends and the means are presumed to be *given*. It is the presumed knowledge of these planning circumstances by the planner that permits the economist to perceive the plan as the solving of a constrained maximization problem. The validity of the plan itself, it should be noted, depends entirely on the validity of the assumption that the planner in fact accurately knows the circumstances surrounding his prospective decisions. If the planner does not know what it is that he is seeking to achieve, or does not know what resources are at his command, or what the efficacy of these resources is with respect to sought-after goals, then his plan—no matter how carefully formulated—is unlikely to result in the best possible outcome.

We can now identify the knowledge problem potentially relevant to each individual plan: *Because of inadequacies in the planner's knowledge of his true circumstances, his plan may fail to yield an attainable optimum.* Let us call *this* knowledge problem the "basic knowledge problem." This will distinguish it from what we have called "Hayek's knowledge problem." It will also indicate our intention to demonstrate that Hayek's knowledge problem can be considered a special case of what we call the "basic knowledge problem."

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To be sure, what we have called the "basic knowledge problem" seems, at first glance, to bear little resemblance to Hayek's. Hayek's knowledge problem consists in the dispersed character of available information; our basic knowledge problem consists in an individual's simple ignorance of the circumstances relevant to his situation. Further reflection on both Hayek's knowledge problem and our basic knowledge problem, however, will reveal the important sense in which Hayek's problem is indeed a basic one. Let us first clarify a possible misunderstanding concerning the basic knowledge problem.

The Basic Knowledge Problem and the Economics of Search

It might be argued that the basic knowledge problem surrounding every individual plan can be entirely escaped through the addition of new planning stages. After all, if a plan seems likely to fail because of inadequate availability of a necessary resource, this threatened failure need not be final; it may possibly be avoided by appropriate preliminary planning to obtain this resource. Instead of simply formulating a single plan directed at the immediate attainment of the final objective, it is necessary to introduce intermediate objectives to be pursued in the course of additional preliminary plans. Perhaps, then, the basic knowledge problem, too, merely calls for judicious preliminary planning.

From this perspective the basic knowledge problem would appear merely to represent an inadequacy in the available supply of an important resource, namely, knowledge. This inadequacy would then be seen to call for a *planned search* to acquire the necessary information. In principle, it might then be thought that the basic knowledge problem can be escaped, at least to the same extent that any other problem arising out of a resource shortage can be escaped. To the extent that it is worthwhile, a preliminary plan of search to overcome the shortage of necessary information may totally eliminate the basic knowledge problem. To the extent that such a costly search is held not to be worthwhile, the basic knowledge problem would seem merely to express the inescapable scarcity constraints inherent in the planner's situation. For the economist such an inescapable scarcity problem means that there is no problem at all, in the relevant sense.

To the extent that the knowledge problem is escapable, it can (and presumably will) be escaped; to the extent that it is not worthwhile escaping, there would appear to be no basic knowledge problem at all—since we defined the basic knowledge problem in terms of failure to realize an *attainable optimum*. If lack of knowledge renders

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a hypothetical optimum unattainable, it can generate no basic knowledge problem. And, if the cost of acquiring the knowledge is prohibitive, then the "hypothetical optimum," while indeed "attainable," is in fact no optimum at all.

But this line of argument cannot be sustained. The basic knowledge problem potentially surrounding each individual plan is by its nature inescapable. Certainly a deficiency in knowledge may be able to be rectified by search, and the individual planner will no doubt consider, in his preliminary planning, whether such search should be undertaken or not. But the basic knowledge problem—involving possible failure to achieve an attainable optimum—remains. In fact the possibility of preliminary planning to acquire knowledge only *expands* the scope of the basic knowledge problem.

Let us consider an individual engaging in a plan seeking to achieve a valued objective. Let us call this "Plan A." In formulating the specific steps that should be taken in pursuing Plan A, the individual realizes that he lacks needed pieces of information. He thereupon engages in a plan to attain these preliminary objectives, namely, these missing pieces of information. Let us call this search plan, "Plan B." We may see Plan A as having been *expanded* (as a result of realized ignorance) to *include* the planned attainment of needed preliminary objectives, so that Plan B is "nested" within expanded Plan A. And we may identify the later steps to be taken in the course of expanded Plan A—those steps subsequent to the attainment of the information obtained in Plan B—as "Plan A′." (Plan A′ consists in the steps that would have made up the originally envisaged Plan A had the planner in fact *not* lacked the needed information.) We can easily see that the basic knowledge problem is a potential hazard both for Plan B and Plan A′. Plan A, which includes Plan B and Plan A′, is of course subject to the vulnerabilities of both of them.

Even if Plan B is completely successful in attaining precisely the optimal amount of information capable of being searched for (and believed to be worth the costs of such search), Plan A is nonetheless still subject to the hazards of the basic knowledge problem. After all, although our decision maker, in originally seeking to formulate Plan A, realized he lacked specific items of information (and therefore undertook preliminary Plan B), he may have in fact *lacked far more information* than he realized. (Most important, such unrealized information may have taken the form of a firm, but totally mistaken, belief in the validity of information that is totally false.) Moreover he may be mistaken in his belief that the items of information he realizes he lacks are necessary for the implementation of Plan A. He also may be mistaken in his belief that he really lacks these items of

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information (in the relevant sense of lacking). The truth may be that these items are already within his grasp.

For example, he may believe that Plan A, in the course of which he must communicate with individual Z, requires information concerning Z's telephone number, information that he believes himself to lack, so that he undertakes Plan B to search for Z's telephone number. But the truth may be quite different. The truth may be that Z is in fact the wrong person to speak to altogether, or again the truth may be that Z is now in the very same room with our planner, so that no knowledge of Z's telephone number is in fact needed for Plan A. Or, it may be, our planner does not really "lack" Z's telephone number at all; he may in fact have that telephone number clearly written and identified in the list of telephone numbers that lies next to the telephone that he uses. Given these possibilities for sheer error that surround Plan A′ and/or Plan B, possibilities in which the planner is entirely unaware of the extent of his ignorance, Plan A (because it includes Plan A′ and Plan B) may be far from optimal even if Plan B is wholly successful in terms of its own objectives. In addition it may be the case that Plan B overlooks more efficient available ways of achieving its own objectives (for example, there may be less costly methods of search of which the searcher is unaware.)

To sum up, the possibility of planned search for information perceived to be lacking does not eliminate the knowledge problem. First, the planned search may itself be undertaken without awareness that more efficient search techniques are easily available. Second, the information sought may in fact not justify the costs of search because the truth (of which the planner is unaware) is that the information is *not* of significance for the attainment of the planner's ultimate objectives. Third, quite apart from the information that the planner realizes he lacks and for which he may attempt to search, he may lack other information that he does *not* realize he lacks and for which he does not think of undertaking any planned search.

Central Planning and the Knowledge Problem

We are now in a position to appreciate Hayek's insight into the problem of dispersed knowledge as revealing *the central planning task to be one that is deeply and inextricably bound up in the basic knowledge problem.* Let us put ourselves in the position of the central planners, earnestly and single-mindedly seeking after the most efficient possible pattern of resource allocation.

Our task as central planners is to formulate a plan for society in a manner analogous to that in which an individual plans his own course

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of action. We formulate our social plan with respect to specific social objectives and in the light of specific perceived arrays of available social resources.[2] This framework for the central plan is relevant (in principle and with the necessary changes having been made) both for comprehensive social planning and for central planning designed merely to supplement or modify, rather than totally replace, decentralized economic activity. The analogy between the social plan and the individual plan compels us, of course, to acknowledge the relevance of the basic knowledge problem for the social plan, in exactly the same way as we have seen it to be an inevitable and inescapable hazard for the individual plan. *Hayek's contribution permits us to recognize that the central plan may be subject to hazards (arising out of the basic knowledge problem) that might have been escaped by decentralized planning.*

That the centralized plan is inescapably subject to the hazards of the basic knowledge problem follows almost trivially from the very notion of the basic knowledge problem. Because the individual planner may not be aware of his true circumstances and may be totally unaware of his ignorance, his best formulated plans may fail to yield an attainable optimum. The central planners, too, may be unaware of their own ignorance concerning the true circumstances relevant to the social plan. Our understanding of the implications of dispersed knowledge deepens our appreciation of the seriousness of the basic knowledge problem, and reveals how the hazards of this problem *might* have been entirely escaped in the absence of the centralized plan.

Recognition of the fact of dispersed knowledge—especially as regards "the knowledge of particular circumstances of time and place" (Hayek, 1945, p. 80)—immediately illuminates our understanding of the basic knowledge problem that threatens central planners. For a planning individual, the basic knowledge problem derives from the possibility that what he thinks he knows about his circumstances may differ from what he *might* have known (without additional resource expenditure) had he been more alert or aware of the true environment.

The same possibility, of course, is fully relevant for a central planner, but it is heightened by the central planner's peculiar predicament. What the central planner thinks he knows about the relevant circumstances *must necessarily take the form of what he thinks he knows about the availability of dispersed bits of knowledge that can*

[2]We avoid here raising any of the well-known difficulties that surround (a) the notion of a hierarchy of social goals analogous to a ranking of individual objectives, and (b) the related notions of social efficiency and social choice.

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somehow, at some cost, be mobilized in formulating and implementing the social plan. There is little chance that the central planner can ever know where to find, or how to search for, all the items of dispersed information known somewhere in the economic system. Moreover there seems little chance that the central planner can ever be fully aware of the nature of extent of the specific gaps in his own knowledge in this regard. He may realize, in a general way, that there is information the location of which he is ignorant, but this gives him no clue on where to look. The end result is that the planner is unlikely to be able to exploit all the information that is within his command. Clearly the dispersal of information is responsible for a new dimension of application for the basic knowledge program.

Earlier we raised the possibility that Hayek's knowledge problem—despite its novelty—might be subsumed under the general economic problem, traditionally conceived in terms of achieving an efficient allocation of given resources (with available information included as an important given resource). We can now see how inappropriate it is for us to consider central planners as being able to grapple with Hayek's knowledge problem in terms of conventional planning to achieve a constrained optimum pattern of resource allocation. The unknown ignorance that is the heart of the knowledge problem created by the dispersal of information defies its being able to be squeezed into the Procrustean bed of the allocation plan. Just as the individual planner is unable to grapple deliberately with the basic knowledge problem surrounding all decision making, so too is the central planner unable to invoke planning techniques to grapple deliberately with Hayek's knowledge problem.

What renders the Hayekian knowledge-problem critique of central planning so devastating is the circumstance that in a market system, with decentralized decision making, *the insoluble knowledge problem confronted by central planners tends to dissolve through the entrepreneurial-competitive discovery procedure.*

The Entrepreneurial-Competitive Discovery Procedure

The Hayekian case for decentralized decision making has frequently been misunderstood. All too frequently this case is presented as arguing only that the decentralized market economy escapes the problem of dispersed knowledge because prices accurately *and economically* convey necessary information to relevant decision makers (replacing any need for them to know *all* the detailed information that is dispersed throughout the system). It must be emphasized that

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while this line of reasoning is certainly present in Hayek's work, it fails to do justice to the full implications of that work.

To argue that market prices convey information, and thus directly overcome the problem of dispersed knowledge, is to make a case for markets that depends upon a dubious assumption; namely, that markets are always at or close to equilibrium. It is only in equilibrium that it can be claimed that a market participant guided by market prices is automatically steered toward those actions that will coordinate smoothly with the actions of all the other (similarly guided) market participants. Moreover, to make the assumption that markets are close to equilibrium is essentially (quite apart from our other reasons for feeling uncomfortable concerning the realism of this assumption) *to beg* (rather than to overcome) the Hayekian problem of dispersed knowledge. After all, just as the phenomenon of dispersed knowledge offers a formidable challenge to central planners, this phenomenon offers markets a wholly analogous challenge, namely, that of *achieving,* in fact, those arrays of market prices that will clear markets.

One does not "solve" the problem of dispersed knowledge by *postulating* prices that will smoothly generate dovetailing decisions. Dispersed knowledge is precisely the reason for the very realistic possibility that market prices at a given date are *unable* to clear markets and to ensure the absence of wasted resources. The truth is that the market *does* possess weapons to combat (if not wholly to conquer) the problem of dispersed knowledge. These weapons are embodied in the workings of the price system, but *not* in the workings of a hypothetical system of equilibrium prices. The importance of prices for coping with the Hayekian knowledge problem does not lie in the accuracy of the information which equilibrium prices convey concerning the actions of others who are similarly informed. Rather, its importance lies in the ability of disequilibrium prices to offer pure profit opportunities that can attract the notice of alert, profit-seeking entrepreneurs. Where market participants have failed to coordinate their activities because of dispersed knowledge, this expresses itself in an array of prices that suggests to alert entrepreneurs where they may win pure profits.

We know very little about the precise way in which pure profit opportunities attract entrepreneurial attention. But there can be little doubt about the powerful magnetism which such opportunities exert. To say that pure profit opportunities attract attention is not at all to say that awareness of these opportunities is secured by deliberate, costly search on the part of entrepreneurs. Rather it is to recognize that the lure of pure profit is what permits an individual decision

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maker to transcend the limits of a given, perceived planning framework, and to escape, to some extent, the basic knowledge problem that surrounds all individual decision making. Man's entrepreneurial alertness operates at all times to place his narrow planning activities within the broader framework of *human action*.[3] *At the very same time* as man is routinely calculating the optimal allocation of given resources with respect to given competing ends, he keeps an entrepreneurial ear cocked for anything that might suggest that the available resources are different from what had been assumed, or that perhaps a different array of goals might be worth striving for.

This entrepreneurial element in human action is what responds to the signals for pure profit that are generated by the errors that arise out of the dispersed knowledge available in society. It is this yeast that ferments the competitive-entrepreneurial discovery process, tending to reveal to market participants more and more of the relevant information scattered throughout the market. It is this entrepreneurial-competitive process that thus grapples with that basic knowledge problem we found inescapably to confront central planning authorities. To the extent that central planning dispaces the entrepreneurial discovery process, whether on the society-wide scale of comprehensive planning or on the more modest scale of state piecemeal intervention in an otherwise free market, the planners are at the same time both smothering the market's ability to transcend the basic knowledge problem and subjecting themselves helplessly to that very problem. The problem's source is Hayek's dispersed knowledge: Central planning has no tools with which to engage the problem of dispersed knowledge, and its very centralization means that the market's discovery process has been impeded, if not brought to a full halt.

Markets, Firms, and Central Planning

At least as far back as Coase's 1937 paper on the theory of the firm, it has been recognized that each firm in a market economy is an island of local "central planning" in a sea of spontaneously seething competitive market forces. Within the firm, activities are coordinated by central direction, not by market competition via a price mechanism. Our discussion in this paper throws light, perhaps, on the forces governing the location of the boundaries separating the realm of freely adopted "central planning" from that of the competitive price system.

[3]On this compare Mises (1949, pp. 253–54).

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We have seen that the replacement of market discovery (working through entrepreneurial alertness to profit opportunities) by central planning generates a new scope of potency for the basic knowledge problem arising out of the dispersal of knowledge. In a free market, therefore, any advantages that may be derived from "central planning" (for example, the avoidance of "wasteful" duplication often apparently present in situations of market rivalry) are purchased at the price of an enhanced knowledge problem. We may expect firms spontaneously to tend to expand to the point where additional advantages of "central" planning are just about offset by the incremental knowledge difficulties that stem from dispersed information. On a small scale these latter difficulties may be insignificant enough to be worth absorbing in order to take advantage of explicitly coordinated organization. Knowledge dispersed over a small geographical or organizational area may mean a Hayekian knowledge problem that is, unlike that relevant to large, complex entities, solvable through deliberate search. Beyond some point, however, the knowledge difficulties will tend to reduce the profitability of firms that are too large. Competition between firms of different sizes and scope will tend, therefore, to reveal the optimal extent of such "central planning."

On the other hand if central planning is *imposed* on an otherwise free market, whether in comprehensive terms or not, such planning will almost always involve the knowledge problem, and to an extent *not* likely to be justified by any advantages that centralization might otherwise afford. Governmentally enforced central planning sweeps away the market's delicate and spontaneous weapons for grappling with the knowledge problem. Such centralized planning is by its very nature, and the nature of the knowledge problem, unable to offer any substitute weapons of its own.

Conclusion

We should remember that the nature of the knowledge problem is such that its extent and seriousness cannot be known in advance. Part of the tragedy of proposals for industrial policy and economic planning is that their well-meaning advocates are totally unaware of the knowledge problem—the problem arising out of unawareness of one's ignorance.

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"ECONOMIC PLANNING AND THE KNOWLEDGE PROBLEM": A COMMENT

Leonid Hurwicz

My comments are directed to issues raised by Professor Kirzner's analysis[1] rather than the various current proposals for a national industrial policy, but I hope that they may be relevant as a background for analyzing such proposals. And, since I shall be indicating my disagreement with some of the points made by Professor Kirzner, let me stress that I am in complete sympathy with his point of departure, namely, the emphasis on the *dispersion of information* among economic decision-making units (called by him, "Hayek's knowledge problem") and the consequent problem of *transmission* of information among those units.

Much of my own research work since the 1950s has been focused on issues in welfare economics viewed from an informational perspective. The ideas of Hayek (whose classes at the London School of Economics I attended during the academic year 1938–39) have played a major role in influencing my thinking and have been so acknowledged. But my ideas have also been influenced by Oskar Lange (University of Chicago, 1940–42), as well as by Ludwig von Mises in whose Geneva seminar I took part during 1938–49.

By now there is a considerable literature in this area.[2] A careful perusal of this literature, I believe, would show that Professor Kirzner's opening statement (that "the Hayekian lesson was simply not grasped by subsequent welfare economists")[3] does not apply to present-day mainstream welfare economics, whether or not it applies to earlier work in this area.

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[1]Kirzner (1984).

[2]An excellent presentation of many recent ideas is found in Reiter (1977).

[3]Kirzner (1984, p. 407).

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Let me make clear at this point that I do not intend to argue the advantages or disadvantages of whatever may be meant by "central planning" or "industrial policy." Rather, my purpose is to instill some skepticism with respect to oversimplified arguments sometimes used in this area. I shall argue that the paper before us—despite its many valuable insights—does not provide an adequate basis for forming a judgment concerning the respective merits of "the free market," "central planning," or other forms of government intervention in the economic process. (This is the Scottish verdict: neither "guilty," nor "not guilty," but "not proven.") This is so for several reasons, including the ambiguity of the terms used, the implicit assumptions postulating a "classical economic environment" (to be defined below), problems of incentives, and value judgments transcending efficiency.

Terms such as "central planning" and "free market" have many interpretations. In analyzing the merits and weaknesses of the market process it is important to distinguish perfectly competitive markets from those that are monopolistic, oligopolistic, or otherwise imperfect. For example, in a decreasing cost industry only a few firms may survive even though there is freedom of entry. Such a market may be called "free," but it is oligopolistic rather than perfectly competitive.

The well-known theorem of welfare economics asserts the Pareto-optimality (efficiency) of *perfectly competitive* equilibrium. But there is no theoretical basis for asserting that monopolistic or oligopolistic markets result in efficient resource allocation. Indeed, elementary analysis shows that uniform price monopoly or oligopoly is, in general, Pareto-inefficient.[4] Moreover, under conditions of increasing returns, perfectly competitive equilibrium is, in general, impossible because profit maximization with parametrically treated prices would call for either a zero or infinite level of output. Therefore, it is difficult to see how one could justify, in the presence of increasing returns, the claim of efficiency of "free markets," whether the latter term is interpreted as perfect competition or merely free entry.

Difficulties with increasing returns constitute but a special case of a more general problem. The theorem guaranteeing the optimality of perfectly competitive equilibrium assumes the absence of externalities, which also excludes public goods.[5]

[4]The so-called Coase Theorem, as I understand it, merely explores the implications of *postulating* that freely acting well-informed economic agents will arrive at a Pareto-optimal allocation. But uniform price monopoly or oligopoly does not satisfy this postulate.

[5]According to the usual definition of a public good, the utilization of its services by person A does not detract from the possibility of utilization by person B. Government or a private party may supply a public good.

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Furthermore, as seen above, there are circumstances (such as increasing returns) where no set of prices can balance supply and demand; hence, perfectly competitive equilibrium is impossible. Thus, to guarantee both the possibility of existence of balancing prices—technically known as the *existence* of perfectly competitive equilibrium—and of the *optimality* of perfectly competitive equilibria, the relevant theorems make a series of assumptions, excluding such phenomena as externalities, public goods, increasing returns, indivisibilities, and so on. When all these assumptions (which rule out the "troublesome" phenomena) are satisfied, we speak of a *classical economy* or a *classical environment.* The theorems guaranteeing the possibility and optimality of perfectly competitive equilibria therefore presuppose a classical environment.

In practice, however, one often encounters nonclassical environments. Pollution is an example of an important negative externality while information derivable from new inventions or pleasure derivable from musical compositions illustrate positive externalities or public goods. National defense is another example of a vitally important public good. Bridges and dams exemplify indivisibilities, and there are many instances of economies of scale—known as "increasing returns (to scale)." I know of no basis for claiming that, in such situations, the free-market process (however defined) would yield optimal resource allocation.

It has been shown in a number of contributions (Mount and Reiter 1974; Osana 1978; Hurwicz 1977) that in classical environments the perfectly competitive price mechanism uses a minimal size message space; that is, it uses the minimum number of variables for transmitting information between economic units. This confirms Hayek's view concerning the informational efficiency of the price mechanism. But it has been shown by examples (Hurwicz 1977; Calsamiglia 1977) that in the absence of convexity,[6] it may be impossible to find any efficient decentralized mechanism using a finite-dimensional message space.

In addition to the difficulties in achieving efficiency in nonclassical environments, one must note that efficiency is only one of the possible criteria on which value judgments concerning economic systems are based. Some people may be prepared to sacrifice efficiency for the sake of egalitarian ideals; for them, the fact that the market process yields efficiency may be insufficient—even if one can assume a classical environment. Of course, this attitude need not lead to the

[6]Increasing returns are a special case of the nonconvexity of a production possibility set.

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discarding of the market process, but perhaps to a supplementation with such devices as taxes or subsidies. Hence a case for some role of the government may be made on value judgment grounds even if it were admitted that government intervention results in lowering the efficiency of the system.

I also see another problem in relating Professor Kirzner's arguments to the above-quoted theorems concerning the optimality of competitive equilibria. The paper before us is emphatic in avoiding reliance on markets actually being *in equilibrium*. But it is only the position of competitive equilibrium which, under classical assumptions, is guaranteed to be optimal. So the best one can say for disequilibrium situations is that they may *tend to* an equilibrium. In fact, a study by Arrow, Block, and the present writer (1959) identified certain classes of situations where such a tendency toward equilibrium (that is, stability) is present. But subsequent research (for example, Scarf 1960) has shown that this tendency is not always present even in perfectly competitive markets. In any case, it is difficult to see how, in the absence of stabilizing forces, a *theoretical claim* can at all be made that markets produce efficiency.[7]

The paper's major emphasis is on what the author calls "the basic knowledge problem." To the extent that this goes beyond Hayek's dispersion of knowledge, this "basic knowledge problem" seems simply to be the fact that most decisions—whether by planners, firms, or individuals—must be made without complete and accurate information.[8] There is no disagreement on this point. But some of the discussion seems to imply that such uncertainty makes any rational behavior *logically* impossible.

With that I cannot agree. There do exist well-developed theories of rational behavior under uncertainty, including the theory of search. Statistical decision theory is but one branch of this discipline. But even if one accepts the practical difficulties of *optimal* search behavior, one is then led to the framework of so-called bounded rationality (Simon 1972; Radner 1975).

I would, of course, agree that people often act on beliefs that are factually incorrect. At best, one can only hope for action that is rational in the light of foresight—not of hindsight. But this difficulty arises for everyone, not just for planners. True, if the planner's information

[7]I stress the term "theoretical" because neither Professor Kirzner nor I attempt to deal with the empirical evidence concerning the actual performance of different types of economic systems.

[8]See Kirzner (1984, p. 410): "[O]ur basic knowledge problem consists in an individual's simple ignorance of the circumstances relevant to his situation."

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or beliefs are based on imperfect *transmission*, this does constitute an *additional* source of error. But that, again, is the Hayek problem!

As mentioned above, the market mechanism does minimize the required message space, but its claims are based on the assumption of classical environments.

In nonclassical environments or where values other than efficiency are important, a case may be made, at least, for the inadequacy of the "free market" process, and possibly in favor of a role for government intervention. But such a role should not be identified with central planning. In fact, this role may be confined to introducing and enforcing what may be called "rules of the game." In particular, this may involve the creation of property rights through patents or copyrights. Creating such rights does amount to government intervention in the free market process but does not constitute what I would call central planning. Similarly, government's role in enforcing income transfers through taxes and subsidies constitutes intervention but not central planning. The latter term should perhaps be reserved for the type of intervention that might be called *micro-targeting*—of which industrial policy or price controls and rationing may be examples, and in which the government makes decisions concerning outputs, inputs, or prices of specific commodities or groups of commodities. Even then it is important to distinguish between all-encompassing central planning (attempted in the Soviet Union) on the one hand, and elements of planning grafted onto an otherwise market-type economy (as is typical of Western countries) on the other. Thus one should recognize that between a laissez-faire economy and an all-inclusive central planning (micro-targeting) system, there is a spectrum of intermediate possibilities, some involving partial micro-targeting and some involving rules-of-the-game government intervention (with no element of planning or micro-targeting).

Personally, I tend to agree with Professor Kirzner that a large modern state is above optimal size as a micro-targeting unit. My reasons—in addition to those in the sphere of knowledge cited by Professor Kirzner—have to do with the discouragement of individual incentives[9] toward efficiency, due to micro-targeting type planning as in the Soviet Union or China. But it does not follow that laissez-faire constitutes a universal panacea.

In particular, a proof has yet to be given that (as claimed on p. 417) "Competition between firms of different sizes and scope will tend . . . to reveal the optimal extent of such 'central planning.' " In

[9]Professor Kirzner does recognize the role of incentives in the search for knowledge. I am referring here to incentives for efficient behavior *given the available knowledge*.

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classical environments this might indeed be the case, but one is entitled to question whether, for instance, the present merger trends in the United States are logically bound to push the economy closer to optimality. If monopoly results, inefficiency might follow.

Let me also enter a dissent to the final statement in the paper—that the advocacy of industrial policy or central planning is necessarily rooted in the lack of awareness of the knowledge problem (". . . their well-meaning advocates are totally unaware of the knowledge problem").[10] In my opinion, lack of appreciation of the importance of incentives may be a more serious problem. (China is an example of a centrally managed economy which has come to recognize the importance of incentives and the merits of decentralization.) Some advocates see industrial policy as a second-best solution in view of the imperfection of domestic and international markets and despite the difficulties due to the problem of knowledge. One may disagree with the judgment that this is indeed a second-best solution, but without imputing to its advocates lack of awareness of some of its disadvantages.

The problem of the appropriate role of markets and of government intervention is complex, and, in my view, panaceas are not to be found at either end of the spectrum. Dispassionate analysis—to which Professor Kirzner's paper is a valuable contribution—shows the merits as well as the deficiencies of polar solutions; it points to the strengths of the market process as well as those imperfections which justify the search for supplementary institutional devices involving public intervention. It is likely that the answers will not please the ideologues of either persuasion.

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[10]Kirzner (1984, p. 417).

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THE INCENTIVE TO INNOVATE UNDER ALTERNATIVE PROPERTY RIGHTS

Steve Pejovich

Introduction

The idea of economic development dominates both the aspirations and the public policy of most countries today. However only capitalist countries have done something about it. The United States, Western Europe, Japan, Hong Kong, and a few other places are true islands of economic affluence in a world that is terribly poor. If overpopulation has created poverty in India, why are people in Hong Kong so much better off? If an inadequate resource base is responsible for poverty in China, why is a resource-poor country like Japan doing so well? The Soviet Union is well-endowed with resources but its leaders are having a rather hard time clothing, feeding, and housing their people. For centuries the Texas plains were among the most uninviting areas of the world; that is, until the incentive effects of a private property, capitalist economy transformed them into one of the most affluent regions on earth.

It is a myth to assert that the shortage of capital is holding back economic development in Eastern Europe, Africa, and Asia. Capital is a very mobile resource which is continuously and untiringly looking for higher yield opportunities. The flow of capital from the North to the South and from the West to the East has not been sufficient to equalize marginal yields, because of political instabilities, currency controls, and/or attenuated property rights in noncapitalist countries. Also, governments of many countries have either inflated their respective economies, or overtaxed their people, or mortgaged their country's resources to foreign creditors, and all of that in the name of economic growth. High growth rates, however, are political

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objectives. They give the economist something to measure, the bureaucrat something to shoot at, and the ruling elite something to shout about. A high rate of economic growth is neither an indicator of economic development nor evidence of its absence.

Empirical evidence carries a simple but true message: Capitalism has done more for the common man than socialism. The purpose of this paper is to establish the link between property rights structures and economic development. To accomplish this objective we shall look into the incentive effects of property rights in Yugoslavia on the flow of innovations. In that sense the paper departs from the general tendency in the property rights literature to analyze the effects of legal structures on the allocation of resources.

Innovation and Economic Development

Innovation means doing something that has not been done before. It could be the development of a new good, the opening up of a new market, a new source of supply, or a new method of production. Innovation diverts resources from previous uses and in the process changes the index of significance of inputs relative to output.[1]

Operationally, innovation is an addition to the set of opportunity choices. It provides the community with a choice between the old ways and a new alternative. A voluntarily accepted innovation makes the community better off. How do we know that? If the community preferred the old ways the innovation would have failed, as indeed many innovations do. However, the community that is compelled by the state or another authority to accept innovation is not necessarily better off.

Innovation refers to changes in the community's set of choices. Moreover it *internalizes* those changes. A successful innovation offsets the law of diminishing returns, and takes the economy from the old to a new equilibrium (Pejovich 1965). The effects of innovation could not then be analyzed within the neoclassical analytical framework.

Innovation introduces a novelty into economic life. It brings about a qualitative change rather than a measurable quantitative growth in the economy. To insist on measuring the effects of innovation misses the point about its true role in society. For example Martens and Young (1979) made an attempt to provide a comparison between the flow of innovations in the Soviet Uniion and in the United States. They concentrated on the number of technical inventions and the

[1]My treatment of innovation and its role in society is Schumpeterian.

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speed of their implementation. This kind of attempt to measure economic development ignores the most relevant issue: What is the vehicle by which the community evaluates the innovation? Technical changes could mean a qualitative improvement in the community's well-being; they could also mean that the community is going to be getting more of something it does not want. *Voluntary* acceptance of innovation enriches the community's welfare. It internalizes the effects of innovation. Thus voluntary acceptance of innovation is a major or true source of economic development.

Innovation cannot be planned. Business firms and governments cannot simply decide to have three innovations per month. Innovation is triggered by the individual who perceives an opportunity to do something that has not been tried before. Innovation is a consequence of his ingenuity.[2] The innovator has no previous data to count on. He faces the risk of doing something which is new—people tend to resist changes. Innovation then depends on man's ingenuity, his guess about people's preferences and incentives to accept the risk of failure. *Innovation is then individualistic in its origin and social in its consequences.* The bottom line is that the community should seek and implement economic policies that promise—and that is all they can do—to maximize the flow of innovation.

The problem of economic development boils down to a search for property rights structures that promise to (1) increase the number of people who can innovate, (2) enhance the individual's incentives to innovate, and (3) provide a mechanism for the integration of innovation into economic life (that is, provide for its acceptance or rejection by the community).

With respect to points (1) and (2) the crucial questions are: Who can innovate and what are the innovator's incentives to accept the risk of failure? To be able to innovate one must have the right to acquire resources, the freedom to negotiate their uses, and sufficient incentives for the risk he takes. With respect to point (3) the issue is to identify the community's judgment of the innovation's costs and benefits.

The right of ownership and contractual freedom are conducive to maximizing the flow of innovation in the community. The right of ownership is a necessary means for the dispersion of power in a society. The right of ownership means that everyone in the community is free *to acquire resources*. Contractual freedom replaces orders from the top with voluntary exchange in competitive markets.

[2]For a very telling story about the frustrations of an innovator in a socialist state, see *Dudincev* (1957).

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It provides the innovator with *the ability to act in the market.* Contractual freedom increases the flow of information about the effects of innovation. It lowers the cost of the integration of innovation and its consequences into relative market prices. In this manner, freedom of contract serves as a vehicle by which the community judges, evaluates, and finally prices the costs and benefits of innovation. The right of ownership and contractual freedom offer incentives to the individual to accept the risk and uncertainty about the outcome of innovation. The gains come from the market's acceptance of innovation. A successful innovation yields benefits in excess of what the bundle of resources used by the innovator was earning before. Positive profits are then created within the system by way of the emergence of new exchange alternatives that enough people seek to exploit. In the process the innovator has a temporary monopoly position that enables him to capture those gains until they are competed away by imitators. In the end the community gets the "right" amount of what it prefers.

The right of ownership and contractual freedom are institutions that are *specific* to capitalism. They maximize the number of people who could innovate, generate incentives for potential innovators to accept the risks of failure, assure the potential innovator of the ability to act in the marketplace, and quickly integrate the costs and benefits of innovation into relative market prices. *These two institutions are conceptually powerful and perhaps necessary requirements for successful economic development.*

There exists a relationship between property rights and economic development. As property rights change, incentives to innovate and consequently the rate of economic development will change as well. Let us now look into the incentive effects of property rights in Yugoslavia on economic development in that country.

Innovation and Economic Development in Yugoslavia

Most research by western scholars has traditionally emphasized the macroeconomic aspects of socialist economies. A predictable outcome of this emphasis on the system of planning and macroeconomic analysis has been a rather poor ex ante understanding of the economic forces at work in socialist countries. Let us look at two examples.

In the 1950s a relatively high rate of growth of the Soviet economy was taken for granted. G. Warren Nutter was among the very few economists who questioned the reported growth rate in the Soviet

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Union, doubted the ability of the Soviet Union to continue to grow at the same rate, and denied the importance of economic growth policies for human welfare. Nutter based his observations and predictions on the standard price theory adjusted to take into consideration the incentive effects of property rights. Nutter was castigated for defying the traditional wisdom. Yet history has validated Nutter's predictions about the Soviet economy (see Nutter 1983).

The 1965 economic reform in Yugoslavia was acclaimed as a major step in the direction of greater efficiency. The reform was supposed to transfer decision-making powers from the bureaucracy to the employees of business firms. Horvat claimed that "self-management accelerated growth of output, and technical progress beyond anything known before" (see Bajt 1983). Vanek thought that self-management should be tried everywhere, and some German economists linked the idea of codetermination with the Yugoslav system of self-management.

In the late 1960s a property rights micro-model was developed that suggested the 1965 reform would generate inflation, low savings, high unemployment, and serious liquidity problems (Furuboth and Pejovich 1974). Moreover it suggested that those problems in Yugoslavia are generated by the labor-participatory system itself. Each and every one of these predictions has turned out to be correct.

The point is that price theory has one advantage over the analysis of aggregate variables: It is capable of contributing to knowledge. In the field of comparative studies, the price theory adjusted for the effects of various property rights has led to a simple general conclusion: *There can be no efficient markets without private property rights* (Nutter 1968). This paper argues that *there can also be no economic development without private ownership.*

Major institutional features of the Yugoslav economic system are (1) the state ownership of capital goods, (2) the employees' ownership of the returns from capital goods held by the firm, (3) the employees' right to govern the firm, (4) the system of quasi-voluntary contracts between firms, institutions, and various agencies, and (5) the substitution of bank credit for the system of administrative distribution of investable funds. When this institutional framework is translated into the bundle of rights that defines ownership in the firm in Yugoslavia, the following picture emerges:

- The employees own the residual.
- The employees have the right to fire and hire the firm's management, including the director.

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- The employees can neither sell the rights specified above nor continue to enjoy them when they leave the employ of the firm.

The right to capture the residual in Yugoslavia is contingent on the association of one's *live* labor with the firm's physical assets.[3] When this association ceases to exist, one's right to capture the residual ceases as well.

The analysis of the relationship between the self-managed economy of Yugoslavia and economic development requires that we assess the effects of property rights structures on the flow of innovation in that country. In accordance with our discussion above, the three following questions are raised: First, who can innovate in Yugoslavia; that is, who is in the position to acquire resources and determine their uses? Second, what incentives does the potential innovator have to accept the risk and uncertainty associated with innovation? Third, how and to what extent does the innovation have to pass the market test?

Who Can Innovate in Yugoslavia

The legal rules limit the right of ownership in Yugoslavia to a few specific assets. Those rules constrain the ability of individuals who are not employed by business firms to acquire and use resources. The set of people who can innovate in Yugoslavia, for all practical purposes, is reduced to the working collective. Some limitations exist within the collective as well. Individual employees cannot acquire and use resources; only the collective can. That is, no individual employee is in the position to translate his perception into actual outcome. He has to sell his idea to the workers' council, which is the highest governing body in the Yugoslav firm. The firm's director is perhaps the only individual who can use resources to implement new ideas. However even the director must seek the workers' council's approval for any major change in the firm's scale of operations (Pejovich 1973). By law the workers' council must include skilled workers, semiskilled workers, as well as blue-collar workers. Thus the workers' council is a group of people with totally diverse interests, different philosophical backgrounds, unequal technical knowledge, and different age distribution. Their understanding of a new venture, ability to comprehend its consequences, and judgment of expected benefits cannot be the same. Moreover the attitude of the members of the workers' council toward the risk is likely to differ from one member of the council to another. Compared to the regime

[3]This is a constitutional requirement in Yugoslavia.

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of private property rights, the prevailing property relations in Yugoslavia must be expected to impede the flow of innovation in the firm.

Incentives to Innovate in Yugoslavia

The employees' right to capture the firm's earnings links the collective's decisions on the one hand and wages received by members of the collective on the other. The relationship between the collective's decisions and the workers' earnings is likely to be stronger in small firms. As the number of the employees increases, their perception of the relationship between their individual efforts and their inputs into decision-making processes on the one hand and take-home wages on the other tends to weaken. A worker who comes up with an idea that potentially may turn out to be a successful innovation will capture only a small fraction of the total gain from his innovation. The larger the size of the labor force, the smaller will be the incentive of the worker to make an effort to perceive new ideas and to sell them to the collective.

The system of property rights in Yugoslavia reduces the director's incentives to innovate as well. A successful innovation in Yugoslavia does not reward the manager as quickly and surely as it does in the West. A successful innovation in the West affects the price of the firm's stock and increases the manager's income because his job opportunities are now enhanced. It is much costlier to generate this kind of information about managers' performance in the markets without private ownership rights.

To understand the link between one's effort and his earnings in Yugoslavia, we shall look at two examples: professional athletes (small group) and the employees of the firm (large group).

Monetary compensation is a powerful and perhaps necessary vehicle for extracting a greater effort from professional athletes. Different methods of rewarding athletes in team-oriented sports stimulate different behavioral responses from individual players. The basic methods of compensation are: fixed payments and performance-oriented payments. The major difference between these two methods of compensation lies in the allocation of risk. Athletes' incomes are almost always a mix of fixed and performance-oriented payments. However, the relative importance of these two types of payments in their total compensation differs from one sport to another and from one country to another.

Fixed contractual salaries provide incentives for athletes to perform well as individuals, to concentrate on their *own* performances. The athlete's future marketability depends on his *own* performance in the field. The athlete has *less* incentive to monitor the performance

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of his teammates, to extol them to a greater effort, and to subordinate his individual actions to the team's interest. It is not argued here that athletes feel no desire for the team to win. The point is that fixed contractual payments shift incentive structures away from joint effort by the team and toward individual performances. However, the method of compensation based on fixed contractual income provides incentives for the club to incur the cost of monitoring its players and of channeling their performance in the direction of joint effort by the team. A testable consequence of this method of compensation would be a relatively larger coaching staff.

When athletes' compensation is performance-oriented, an individual player has incentives to contribute to the team's joint effort, to monitor the performance of his teammates, and to subordinate his individual performance to the team's interest. A predictable consequence of the performance-oriented method of compensation is then a relatively smaller coaching staff; incentives to invest in monitoring activity shifts here toward the players themselves.

The method of payments to professional athletes in Yugoslavia is consistent with the principle of self-management—it is performance-oriented. An example discussed in this paper is the payment schedule used by Partizan, a leading Yugoslav soccer team. Information is for 1977. Earnings are expressed in dollars.

In 1977 the players received fixed monthly compensation from the club. Compensation ranged from $305 per month to $174 per month. For a professional athlete this scale is not very impressive. In the same year the average wage in Yugoslavia was about $230 per month. However, the players' income depended on the team's success in several different types of competition. The most important and certainly the longest (34 games) is the Yugoslav national soccer championship.

The players' compensation for participating in the Yugoslav national championship is based on the team's performance per unit. One unit consists of four championship games. Winning a game is counted as two points, a tie as one point, and a loss as zero points. That is, the team might have been credited by zero to eight points per unit of four games. The players were rewarded as follows:

Number of Points	Compensation
0–3 points	$0
4 points	$192
5 points	$613
6 points	$1,073
7 points	$1,380
8 points	$1,687

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These rewards were received by all individual players regardless of their fixed monthly pay. Assuming that the team played four games per month, the difference in players' monthly earnings between winning 50 percent and 75 percent of their monthly games is quite startling.

If Partizan lost all four games, the lowest player's income in that month would be $174, or 75 percent of the Yugoslav average. But if the team won two out of four games, his monthly income would have been $366, or 159 percent of the national average. If Partizan won three games and lost one, the lowest player's income during that month would have been $1,247, or about 5.4 times above the Yugoslav average. Incidentally Partizan won the Yugoslav national championship in 1977 and each player received an additional bonus of $6,600.

The performance-oriented incentives are not so clearly visible in larger firms. Our discussion here is based on Table 1, which provides a concrete example of the Yugoslav firm (Pejovich 1980). The accounting period is from January 1, 1978 to June 30, 1978.

Several items in Table 1 require special comment because of their effects on the relationship between the property right structures in Yugoslavia and incentives.

Dohodak (value-added) is equal to the firm's total revenue less production expenses and depreciation. It is the most important category in the Yugoslav system of labor self-management. The working collective has incentives to minimize production expenses because there exists a positive relationship between the workers' present and future incomes on the one hand and the size of *dohodak* on the other. The republic and local government also have incentives to monitor expenses incurred by enterprises. Their tax revenues depend on the size of *dohodak*. An interesting feature of the Yugoslav tax system is that only custom duties and turnover taxes are paid into the federal budget.

The government closely monitors the financial transactions of Yugoslav firms. The watchdog is the Office for Social Bookkeeping. *Yugoslav firms can make payments to others neither directly nor through banks.* Financial transactions must first be cleared through the Office for Social Bookkeeping. In fact it is the Office for Social Bookkeeping which instructs banks to make payments on behalf of enterprises. The Office for Social Bookkeeping is primarily concerned with the legality of payments rather than their business justifications. At the same time the director of the firm, the management group, and other influential members of the collective (for example, the chairman of the workers' council), can increase their total

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TABLE 1

DISTRIBUTION OF TOTAL REVENUE OF THE YUGOSLAV FIRM (In Dollars)

Total Revenue		21,405,972
Production Expenses		−18,725,928
Cost of goods	17,142,172	
Business expenses	1,527,680	
Bad debts	6,158	
Inventory adjustments	21,844	
Legal costs and penalties	1,797	
Depreciation		−91,166
Value-Added *(Dohodak)*		2,588,739
Fixed Legal Obligations		−44,595
Insurance premiums	28,421	
Disability compensation	1,123	
Land tax	10,441	
Entertainment and gift tax	2,444	
Solidarity fund (to alleviate damage caused by floods, and other disasters)	2,166	
Variable Legal Payments (dependent on the size of *dohodak*)		−310,181
Republic tax (7%)	89,473	
Education tax (5.5%)	69,604	
Tax for science (0.69%)	8,732	
Retirement & disabil. insur. (7.26%)	91,878	
Tax for child protection (1.81%)	22,906	
Health insurance (0.68%)	8,605	
Building fund (1.5%)	18,983	
Contractual Obligations		−458,230
Administration costs	130,055	
Interest and bank charges	309,701	
Trade association dues	10,869	
Civil defense	5,308	
Legal costs	1,797	
Residual (Enterprise Net Income)		1,775,372
Allocation to Business Fund		698,701
Allocation to Collective Consumption Fund		151,794
Allocation to Reserve Fund		64,709
Allocation to Wage Fund		860,168

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Taxes for Wage Fund (32%)		273,107
County tax (1.41%)	12,128	
Social protection tax (0.52%)	4,472	
Education tax (8.11%)	69,760	
Culture tax (0.77%)	6,624	
Physical education tax (0.16%)	1,376	
Child protection tax (0.88%)	7,569	
Employment agency tax (0.24%)	2,065	
Retirement & disability tax (5.97%)	51,352	
Health tax (7.89%)	67,867	
Other taxes (5.8%)	49,888	
Net Wage Fund		587,061
Average Monthly Wage (330 employees)		296

SOURCE: *Contemporary Practice (Savremena Praksa)*, Belgrade: SDK (Social Accounting Service), 1978, p. 703.

compensation by way of the consumption of nonpecuniary goods such as frequent business trips, sponsorship of conferences, use of company cars, and banquets for business associates. While incentives to minimize production expenses exist in Yugoslavia, the positive costs of monitoring the director and his associates suggest that some unnecessary expenditures can be presumed.

Taxable *dohodak* is different from the firm's total *dohodak*. To calculate the plant's taxable *dohodak*, which in our case is $41,265,542, adjustments are made in the firm's actual *dohodak* of $2,588,378. The firm is allowed to subtract from its *dohodak* the amount equal to the employees' guaranteed income. A worker's guaranteed monthly income is 55 percent of the last year's average personal income in the county where the firm is located. Clearly, guaranteed monthly income varies from one locality to another and from one year to another. Other deductible expenses include contribution to the administrative cost of the firm, loans that the firm must make for the development of less-developed areas of the country, interest payments and other bank charges, insurance premiums, membership dues, contributions to the building fund, and subsidized meals for workers.

Taxes that are paid from the firm's *dohodak*, with one exception (the republic tax), are paid into the budgets of self-managing communities of interest. The institution called the self-managing community of interest has important bearings on the relationship between property rights and incentives in Yugoslavia. The provision of many services, such as welfare, health, education and retirement, is negotiated contractually by organizations that represent those who

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supply specific services and organizations that represent those who demand them. They form self-managed organizations governing a region. For example, in the field of health, a self-managed agreement on the formation of a self-managed community of interest is made between self-managing organizations and other institutions representing those who are eligible by law to receive health services on the one hand and self-managing organizations which provide those services on the other (hospitals, clinics, medical institutes, pharmacies, and so on). Territorial boundaries of the regions are determined by such factors as the economic conditions of life in the area, homogeneity of the population, the area's geography and the availability of health services. The law specifies the minimum provision of services that must be provided by the self-managing communities of interest. However, contractual partners are free to negotiate the provision of additional services. They also negotiate the cost of services and determine taxes that would raise the required revenue. It means that taxes could vary from one region to another as well as from one year to another. Importantly, education, health protection, retirement, and other public services in Yugoslavia are not provided through state budgets. Taxes for these services are not paid into state budgets.

The *residual* belongs to the collective. According to Yugoslav law, the residual must be allocated among the business fund, the collective consumption fund, the reserve fund, and the wage fund. The workers' council determines the allocation of the residual among all these funds, as well as the distribution of the wage fund among the individual employees. However, the workers' council must publicly announce its distributional criteria well in advance or have them approved by the collective at the general meeting. In deciding the scheme for the distribution of the firm's residual, the workers' council is expected to adhere to distributional guidelines stated in self-management agreements that are explained below.

The distribution of the wage fund among the firm's employees is usually regulated in the following way: The workers' council attaches a certain number of points to each position in the firm. The criteria used to determine the number of points for each job usually include skill required, education, health risk, hardship, working conditions, and the like. Those are general criteria used in Yugoslavia, but the relative importance differs from one firm to another. In addition self-management agreements provide general guidelines for individual workers' councils. The firm's wage fund after taxes is divided by the total number of points. The value of a point is then multiplied by the number of points associated with each job, and the result is the employee's take-home income for that accounting period.

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Incentives to innovate clearly exist in the firm, but they are not strong enough to offset risk and effort. Suppose the manager is paid five times the average monthly wage; that is, $1,480. In accepting the risk and effort of innovating and raising the firm's *dohodak* by 10 percent, or $43,145, the manager will add only about $148 to his salary. And the absence of financial markets will impede his chances of capturing even those meager gains in the form of higher income.

Taxes paid from the wage fund are primarily paid into the budgets of local political units and self-managing communities of interest. These taxes vary from one region to another and their uses are specified. As was pointed out earlier, the Yugoslav tax system relates the benefits of various public activities financed through taxes to their costs. There is a relationship between the cost of public services provided in Yugoslavia at the local level and the costs borne by the collective. This fact provides incentives for the collective to try to argue for benefits that are commensurate with costs. It also provides incentives for those who offer public services to seek cost-reducing innovations.

The Integration of Innovations into Social Economy

The market for consumer goods and the system of contractual agreements assure members of the community that those innovations that are beneficial to it will eventually be incorporated into social life. Such an assurance does not exist in other socialist states. While the market for consumer goods in Yugoslavia works the way competitive markets work elsewhere, the system of contractual agreements is a unique phenomenon. The employees in the Yugoslav firm are considered to be contractual partners in the team decision-making processes. Plants within each firm negotiate written contracts among themselves. These contracts specify their mutual rights and obligations. Institutions and firms in related activities negotiate contracts that specify the pooling of resources, criteria for the distribution of income, and other business matters. These contracts are called self-management agreements (*samoupravni sporazumi*). Groups bound together through broad common interests, such as firms, trade associations, labor unions, institutes, and government bureaus, negotiate the so-called social contracts *(drustveni ugovori)* that specify their mutual rights and obligations. Provision of welfare, health, education, and other services, as we have already noted, is negotiated between those who demand social services and those who supply them. In this manner contractual agreements encompass the entire social and economic life in Yugoslavia.

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Contractual agreements are not voluntary. They are mandated by law and the basic terms are frequently stipulated in advance (for example, the minimum health care). However, within these constraints, the terms of contracts are freely negotiated among the participants. An immediate consequence of the Yugoslav system of contracts is to *reduce* the role of the state in regulating and controling economic life. The difference between contracts in Yugoslavia and contracts, say, in the United States is with respect to the role of consideration. In the United States the courts are not supposed to look into the adequacy of consideration, only its existence. The presumption is that the parties involved know better (than the judge) their preferences and the relative values of things that are being exchanged. In Yugoslavia the adequacy of consideration is controled by the state. This implies some price controls and the consequent allocation effects. However, a dynamic, and perhaps the most important, consequence of the system of contractual agreements in Yugoslavia is that it creates incentives for the participants to seek ever greater freedom for themselves in negotiating the terms of contractual agreements.

State Ownership of Capital Goods, Restrictions on Contractual Freedom, and Economic Development in Yugoslavia

The state ownership of capital goods precludes *the capitalization of the future benefits of a successful innovation into their present market value.* The employees of the Yugoslav firm are free to exchange their current consumption for higher future income by leaving a part of the firm's earnings for investment in new ideas. Yet they can neither sell their claims to future earnings in future investments made by the firm during the period of their employment nor continue to receive their share of those earnings once they leave the employ of that firm. It follows that the employees capture the benefits from innovation in the form of higher wages. When a worker leaves the firm, he loses all his claims to the future returns despite the fact that his earlier sacrifice of current income (that is, his share of investment) helped the firm to finance innovation. Given the cost of innovation, the relationship between the worker's time horizon (that is, the worker's expected employment by the firm) and the period of time over which the benefits of a successful innovation are to be received becomes important. Incentives to innovate will tend to fall as the worker's time horizon gets shorter relative to the expected life of innovation.

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The nontransferability of the worker's right of ownership in the firm's earnings means that prevailing property rights structures in Yugoslavia provide no room for diversification in risk bearing among individual workers whose risk aversion is not likely to be the same.[4] Thus the employees of the Yugoslav firm must have incentives to seek those investment ventures and to prefer those innovations whose outcome is to shift income forward and postpone cost. That is, the Yugoslav economic system provides incentives for the collective to seek innovations that maximize the near-term cash flow.

A constitutional requirement in Yugoslavia, which stems directly from the ideology that gave birth to the state ownership of capital goods, is that "live labor must be combined with capital goods in order to receive the residual." The late Edward Kardelj, a leading Yugoslav theoretician and party leader, wrote (1981, p. 147):

> The social and historical substance of self-management lies in the emergence of a form of production relations based on state ownership of capital. . . . The worker appropriates on the basis of his work *directly*, free from all forms of wage labor relations. . . .

A consequence of the requirement that the returns from capital assets belong to workers who use them is to reduce opportunities for the members of the collective to seek entrepreneurial gains outside their firm. Some years ago this point was recognized by Bajt (1968, p. 3):

> If one wants to develop innovating activity in socialist enterprises, one has to provide enterprises with adequate legal rights in order to exchange factors and products in as free a manner as possible. . . . I would not be surprised, therefore, if somewhere in the future this will find its expression in giving enterprises property rights in their means of production.

In the late 1960s the Yugoslav firm was free to determine the allocation of its net earnings between the wage fund and other funds. The share of the wage fund in the firm's net earnings rose from 60 percent in 1964 to over 80 percent in 1970. The Yugoslav government was looking for a different outcome. The government wanted business firms to increase the share of their earnings allocated for investment purposes. The Yugoslav leaders clearly misread incentives inherent in the prevailing property right structures in that

[4]On the general point that lack of private property rights precludes risk diversification, see Jensen and Mechling (1979).

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country. The 1965 reform created incentives for one type of behavior while the state expected different behavior.

In the early 1970s the government decided to interfere with the allocation of resources within the firm and to lower the ratio of wages to retained earnings. The government also decided to refrain from reintroducing direct administrative controls. As we have seen, the vehicles used by the government were to enlarge the role of contractual agreements and to impose constraints on their terms. The law required firms, institutions, and other economic organizations to negotiate social contracts stipulating, among other things, the criteria for allocating enterprises' net income. The government reserved for itself, so to speak, the right to assess the adequacy of consideration.

In order to examine the effects of governmental controls in Yugoslavia on incentives to innovate, let us consider the 1982 social contract for the city of Belgrade and compare it with the social contract for 1972.[5] The social contract stipulates rules for the allocation of enterprises' net income between the wage fund and retained earnings.[6] The crucial variable is the ratio of net income or earnings (E) to adjusted labor (L); that is, E/L.

The term "adjusted labor" refers to a labor-force figure adjusted for differences in skill and education levels, which vary among firms. The approach used in Belgrade in 1972 and 1982 was to attach a coefficient to each level of skill and education. The *adjusted* labor force was then obtained for each firm by multiplying the number of employees in each category by the relevant coefficients and summing the products. The coefficients used in 1972 and 1982 were as follows: 1.00 for an unskilled worker; 1.20 for a semiskilled worker or a worker with less than a high school education; 1.70 for a qualified worker or a worker with a high school education; 2.20 for a highly qualified worker; 3.00 for a worker with a college education; 3.30 for a worker with a master's degree; and 3.80 for a worker with a doctorate.

After determining all the enterprises' labor-adjusted earnings, the E/L ratios are stated in terms of index numbers, with the average earnings per adjusted labor set equal to 100. The social contracts then stipulate the share of earnings that must be retained (R/E) at each different E/L ratio. Since the share of earnings going to the wage fund (W/E) and the share of earnings retained (R/E) must sum to 100, W/E is determinate. The product of the E/L and W/E ratios gives us

[5]See the *Collection of Regulations* (1982).

[6]Earnings are retained for allocation to the business fund, the collective consumption fund, and the reserve fund. Hereafter we shall simply refer to these funds as the "internal funds' or retained earnings.

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the ratio of wages per adjusted labor (W/L) at each different E/L ratio. These ratios are presented in Table 2, which shows the allocation of net income or earnings in Belgrade enterprises under the social contracts in 1972 and 1982.

The data in Table 2 can be used to help uncover the system of rewards implicit in the 1982 social contract for Belgrade and to make comparisons with the incentive structure in 1972. Figure 1 plots the allowable wage per worker (W/L) against earnings per worker (E/L), and shows that greater earnings by the firm yield only modest gains to workers in terms of current rewards. For example, in 1982 if earnings per worker doubled from 100 to 200, the wage per worker would have increased from 78 to 108, or only by 38 percent. The curve relating W/L to E/L moves further and further away from the 45° line (the maximum reward line) as earnings per worker are increased. From the point of view of the collective, this mandated reward system, which constrains the allocation of earnings between the wage fund and retained earnings, is inefficient. The fact that the state needs social contracts in order to increase the share of retained earnings is the best evidence that workers would prefer to allocate a larger share of the firm's earnings to the wage fund. Thus social contracts for both years penalize workers in an efficient firm for their efforts toward still greater efficiency.

What can we say about the effects of social contracts on incentives to innovate? Innovation is a risky venture and a successful innovation yields large benefits. In fact the benefits must be large and capturable to alleviate the risk. Figure 1 tells us that the larger the expected benefits from innovation, the greater is the distortion from the 45° line. Since the benefits expected from retained earnings (that is, from investment) are not transferable in Yugoslavia and can be captured only while a worker remains employed by his firm (the time horizon problem), the 1972 and 1982 social contracts can be said to have reduced the collective's incentives to take risks associated with innovation. Moreover Figure 1 suggests that the incentives to innovate have been reduced between 1972 and 1982. In comparison with 1972, the 1982 social contract clearly reduces the collective's incentives to seek risky ventures.

Conclusion

We can summarize our discussion on the relationship between property rights in Yugoslavia and incentives to innovate as follows. First, the employees' right to govern the firm transfers the right to acquire and use resources needed for innovation from the

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TABLE 2

SOCIAL CONTRACT FOR BELGRADE ENTERPRISES, 1972 AND 1982

Earnings per Adjusted Labor (E/L)	Allocation to Internal Funds (R/E)		Allocation to Wage Fund (W/E)		Allowable Wage per Worker (W/L)	
	1972	1982	1972	1982	1972	1982
260	53	57	47	43	122	112
250	52	55	48	45	120	112
240	51	54	49	46	118	110
230	49	52	51	48	117	110
220	48	50	52	50	114	110
210	45	48	55	52	115	109
200	44	46	56	54	112	108
190	43	43	57	57	108	108
180	42	40	58	60	104	108
170	41	37	59	63	100	107
160	40	33	60	67	96	107
150	38	29	62	71	93	104
140	37	28	63	72	88	101
130	35	27	65	73	84	95
120	33	25	67	75	80	90
110	30	24	70	76	77	84
100	27	22	73	78	73	78
90	23	20	78	80	69	72
80	19	15	81	85	65	68
70	13	11	87	89	61	62
60	5	5	95	95	57	57

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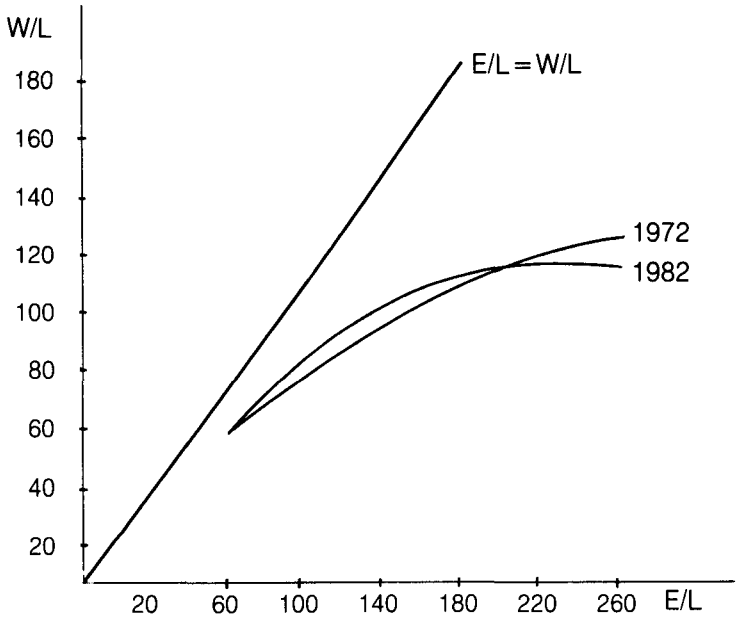

FIGURE 1
EFFECT OF SOCIAL CONTRACTS ON THE ALLOCATION OF NET INCOME

bureaucracy to the working cooperative. Therein lies the major difference between the Soviet economy and the Yugoslav economy. Second, the employees' right to appropriate the firm's earnings establishes a link between the outcome of innovation and the employees' welfare. Third, the market for consumer goods and the system for contractual agreements assures the community that the role of bureaucracy in compelling the community to accept innovation is reduced.

As we look at the relationship between the property rights structures in Yugoslavia and incentives to innovate, we must conclude that in comparison with other socialist states in the East, the incentives to innovate in Yugoslavia are significantly greater. However, with respect to the capitalist West, they are significantly smaller. Only members of the working collective can innovate in Yugoslavia. Within the working collective, decisions to innovate must be approved by the collective as a whole. The link between innovation and its economic benefits are not as strong as they are in the West.

The process of integrating innovation into the social system in Yugoslavia differs from other socialist states. In the East, innovation

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is integrated into social life *via* either approval by the ruling elite or informal managerial practices (Furubotn and Pejovich 1974). In Yugoslavia the role of bureaucracy is still there, but it is diminished. The major factor that controls the integration of innovation into social life is its acceptance by the community *via* the market for consumer goods and various types of contractual agreements. The integration of successful innovation into social life also differs between Yugoslavia and the West. The right of ownership and contractual freedom in the West provide a low-cost vehicle for speedy integration of the cost and benefits of innovation into relative price structures. In Yugoslavia the terms of contractual agreements are far from being freely negotiated. There are also price controls in the market for consumer goods. Thus the integration of successful innovation into the social life cannot be expected to be quick and accomplished at as low a cost as in the West.

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"THE INCENTIVE TO INNOVATE UNDER ALTERNATIVE PROPERTY RIGHTS": A COMMENT

Deborah Duff Milenkovitch

I am in broad agreement with Pejovich's description of property rights in Yugoslavia. He has defined a complex system of property rights very clearly and has established beyond any doubt that the property rights are such as to provide a stronger relationship between enterprise earnings and individual earnings than is true in conventional socialism, and a weaker one than is true in capitalism (Pejovich 1984). Thus the system of workers' management is an intermediate stage in the property rights continuum. He has also clearly pointed to the greater role of the market mechanism in Yugoslavia and its importance in providing greater opportunities for social validation of resource allocation decisions, a social validation that is lacking in the socialist countries of Eastern Europe.

Pejovich evaluates these conclusions about Yugoslavia's property rights in a framework in which the existence of full property rights by individuals and full social validation of innovation through the market mechanism becomes the *only* standard by which to evaluate a property rights system. This approach has two limitations. First, in order to establish the correspondence between full rights of ownership and freedom of contract and social well-being, Pejovich must make some additional (unstated) assumptions about the effects of changes in property rights on the performance of the system. I shall try to identify these assumptions and their role in his conclusions. Second, in arguing for the superiority of a system on the grounds of logic, he departs from his own standards of social evaluation by the choices of the individuals faced with these alternative systems; his argument thereby becomes inconsistent. By identifying these unstated assumptions and logical inconsistencies, and removing them from

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the argument, we can better see what we really know, and where to advance our knowledge about the impact of property rights on the welfare of the common man.

Pejovich's Argument about Innovation and Property Rights

Pejovich discusses the effect of the system of property rights on the incentive to innovate. He uses the concept of innovation in its Schumpeterian sense. The entrepreneur ceaselessly scans the horizon searching for new opportunities, either new ways to produce or new products to produce. The entrepreneur is motivated by the prospect of the short-term gain from being the first to see and try a new idea; in the long run the profits will be eroded as others duplicate his activity. Thus it is the entrepreneur who brings new methods into production; and it is the process of creative destruction of the old and the successful imitation of the new that propels society forward.

The elements of Pejovich's argument can be listed as follows:

1. Innovation means an addition to the set of opportunity choices.
2. The community faces a choice between the old way and the new alternative.
3. A voluntarily accepted innovation makes the community better off.
4. The property rights structure influences (a) the number of people who can innovate; (b) the incentives for individuals to integrate; and (c) the mechanism for acceptance or rejection of the innovation by the community.
5. The right of ownership means that everyone in the community is free to acquire resources for the purpose of innovation. The right of ownership offers incentives to the individual to accept risk and uncertainty. Contractual freedom means that individuals are free to make their own choices in accordance with their own preferences. Contractual freedom serves as a vehicle by which the community accepts or rejects the innovation resulting from entrepreneurial activity (social validation).
6. When the right of ownership is combined with contractual freedom, we have the characteristic property rights of capitalism.[1]

[1]The notion of ownership involves a number of different rights which in capitalism are bundled together (Pejovich 1965; Milenkovitch 1971): (a) The right to use property for personal production and consumption; (b) the right to use property personally for market production and to sell the produce and retain the proceeds; (c) the right to rent property to others and to receive income therefrom; (d) the right to keep property

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7. These rights are necessary for optimal innovation. The right of ownership and contractual freedom maximize the number of people who can innovate, generate optimal incentives for potential innovators to accept the risks of failure, and most efficiently provide for social evaluation of the innovation through the market mechanism.

Limitations of the Argument

The argument seems logically convincing. A comparison of Langean market socialism, worker-managed market socialism, and competitive capitalism (under conditions of self-interested behavior and risk bearing) shows that given certain assumptions, no system can perform better than competitive capitalism (Milenkovitch 1983). Further, only systems with institutions that mimic capitalist institutions can emulate competitive capitalism's superior entrepreneurial performance.

This conclusion is reached by comparing the behavior of the alternative system of property rights with the behavior of the competitive capitalist system. The conclusion rests on the validity of the comparison; that is, *on the assumption about what things remain unchanged when the system of property rights changes.* Let us explore what things besides the incentive to take risks for expected returns and social valuation of the results through the market mechanism might change as a function of property rights.

As Pejovich notes, the incentives for shirking may be different in worker-managed as opposed to capitalist firms. However, he does not relate this observation to the question of the choice of technique across systems. There may be systematic differences across systems, based on the need to monitor and control labor performance, in the kinds of innovations that pay off (Noble 1979). Thus, in a capitalist system, certain kinds of innovations could fail the test of the market because under capitalist production relations they have low returns due to the high cost of monitoring the behavior of the workers. Therefore the techniques chosen may differ across systems. If workers had less incentive to shirk and more incentive to monitor one another in an alternate property rights system, highly productive

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without using it; (e) the right to alter the nature of property; (f) the right to use up or deplete property; (g) the right to sell physical property; (h) the right to liquidate a going concern; and (i) the right to sell shares of a going concern.

When these property rights are bundled together, we have the form of ownership characteristic of capitalism. Other systems—feudalism, slavery, socialism—can be distinguished by different bundling of the property rights. When the right of ownership is combined with contractual freedom, we have the characteristic rights of capitalism.

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techniques, rejected under capitalism, might come into operation. As a result the production function need not be the same across systems.

Pejovich assumes individual agents who maximize utility responding to the prices offered for supply of factors of production and risk bearing. Utility is a function of income and independent of the system of property rights. To the extent that other factors motivate the supply of entrepreneurship—pride in one's own work, value placed on external recognition not translated into monetary terms, altruism—outcomes may be different. The significance of all three factors might be greater under alternative property rights that are not focused solely on financial returns to individual suppliers of factors.

The workers on the production line may have specific knowledge about ways to improve the production process, due to their specific on-the-job training. An individual worker may have an idea, but the costs borne by the individual worker of obtaining the resources to implement his idea may be high relative to the gain borne by the individual. Pejovich focuses on the disincentive to innovate when the benefits are shared in a cooperative, but does not give equivalent treatment to the possible positive incentive to innovate due to the shared nature of the start-up costs. If an alternate system of property rights increases the likelihood of contributions from the workers, that system may have higher gains in productivity from innovations.

The capacity to internalize externalities might differ across systems. For example, there could be higher subjective levels of satisfaction or lowering of stress associated with work after an innovation has occurred. To the extent that not all of the gains of the innovation are appropriable by the entrepreneur, and some of them may be appropriated by the workers, worker-managers may be better situated to internalize the externalities.

Pejovich's conclusions have to be reconsidered under the following conditions: (a) If the set of usable innovations is greater under workers' management; (b) if the incentives to provide innovations is greater for any given monetary reward; (c) if the expected productivity of workers' contributions to innovations are greater than those of citizens at large; or (d) if the possibilities of internalizing the externalities are different. Thus we can *logically* draw up a different set of assumptions about the nature of reality under alternative sets of property rights. Given these alternative assumptions the property rights system will help determine incentives, ability to internalize the externalities, location of knowledge most likely to yield productive innovations, appropriability of the returns to an innovation, impact on technological choice of the need to monitor, and the distribution

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of shared costs and shared benefits. Such assumptions could *logically* yield conclusions different from those Pejovich reaches. To discriminate among alternative hypotheses about reality, we have to resort to some form of measurement and hypothesis testing. Otherwise we are stuck within a sterile logical deduction exercise in which the assumptions, as always, contain the conclusions.

The Relationship of Property Rights to Development

Pejovich relates his discussion of entrepreneurship to economic development:

- "[V]oluntary acceptance of innovation is a major or true source of economic development" (p. 429);
- "The problem of economic development boils down to a search for property rights structures . . ." (p. 429);
- "This paper argues that *there can also be no economic development without private ownership*" (p. 431).

This last is a very strong proposition. Does Pejovich persuade us?

Partly this is a question of definitions. Clearly this is not the dominant way in which development is used in economics. A process that most economists would identify as economic development occurs when, in a poor, agrarian country, sufficient capital is found to extend the availability of best techniques to all producers, transforming an economy out of a vicious circle of low productivity, low income, low savings, low investment, high fertility, high population increase, and low per capita productivity and low income.

Pejovich assumes global frictionless capital markets, so that capital will flow effortlessly to any use where the marginal rate of return is higher for equivalent risk. Capital shortage, by assumption, cannot be a problem in Pejovich's framework. Therefore the only barrier to development is insufficient entrepreneurship due to insufficiently developed incentives in the system of property rights.

Is this a useful frame of analysis? This seems to fly in the face of much of the experience of developing countries, which suggests that capital shortage *is* a problem, perhaps the principal problem of development. But is it a problem only because of inept policies on the part of the developing countries which have tried to restrict the flows of capital?

The North-South literature (Burgstaller 1983) shows, within the framework of neoclassical general equilibrium modeling and classical assumptions about unlimited supplies of labor in the South, imported capital from the North can both relatively and absolutely

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impoverish the South. Therefore a policy on the part of the South of restricting capital flows from the North and focusing on generating Southern capital could be beneficial to the local welfare of the South.

Further, theory shows that global factor mobility will maximize global welfare through equalizing marginal factor productivity. This, however, does not ensure that the groups initially having low capital endowments will be better off, although they could remain equally well off if the North bribed the South to accept free trade and capital flows. In the absence of bribery on the part of the North, to improve its position the South needs to increase its stocks of capital, through self-generated savings. The capacity to generate savings may not be independent of the system of property rights. The "prisoners' dilemma" may operate in the savings decisions. If there is an increase in the supply of capital, this will cause an upward shift in the marginal product of labor function. If the supply of labor remains the same, but the demand for labor increases as a result of the shift, the wage rate will rise. Thus a portion of the return to the increase in the supply of capital does not accrue to the suppliers of capital if they are different from the workers. The marginal private benefits to suppliers of capital are less than the marginal social benefit to society. If each individual supplier must make these decisions in isolation, too little capital will be supplied. If society is homogeneous in its time preferences, then a collective choice to supply capital would result in an optimal rate of capital formation. If society is not homogeneous in its time preferences, then we have no way of unambiguously ranking a collective choice representing the will of the majority over individual choices which give a better representation to the will of the minority, or of ranking them the other way around.

Local shortage of capital is a real phenomenon of development, not one to be ruled out of existence a priori by assumptions that what is good for the world as a whole must be beneficial to the South. If the shortage of capital is real, then useful discussion of economic development and property rights will give attention to the impact of property rights on increasing the local supply of capital, and not just to entrepreneurship.

The Difficult Case for Property Rights: Japan

Clearly, by any definition, Japan has experienced substantial successful innovation in the post–World War II period. More important, Japan's economic system defies any simple location of identifiable property rights for several reasons. First, the role of equity capital appears to be quite different in Japan. While there is private equity

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capital, the debt/equity ratio may be the reverse of that in the United States, about 80/20 or 70/30. In addition much of the equity is held by other institutions, not individuals, in a series of interlocking ownerships and directorships. The suppliers of debt financing are in a more controlling position than the holders of equity capital. Further, equity capital turns over only rarely and there is no ongoing market on which to record the impact on the value of the assets of different managerial decisions. Second, a large portion of the savings is provided by individual citizens through the postal savings system and processed through the Japan Development Bank and the Fiscal Investment and Loan Plan, which have no equity ownership but which convert these funds into investment loans. And third, a major property right does exist in the form of job tenure and a reward system based on seniority and variable bonuses for the males who obtain employment in the major corporations. It is, however, nonmarketable and nontransferable.

According to the property rights analysis, Japan lacks classic capitalistic property rights and should therefore be deficient in entrepreneurship. This does not appear to be the case.

Capitalism Is the Best System for the Common Man

Pejovich claims that capitalism has produced a standard of living that no other system can match. However, when the argument is stated in this form, there is no way to separate the effect of an economic system from natural endowments and historical circumstances in determining the standard of living.

His point about the necessity of differentiating between growth rates of GNP and the well-being of the consumer is an important one. However, it is not immediately obvious how to make a comparison of the effects of economic system upon the well-being of the consumer. Table 1 shows that for many intervals, the annual rates of growth of per capita consumption in the USSR have exceeded those in the United States.

There are, of course, problems involved in meaningfully measuring consumption improvements for two societies when in one of them consumption is not composed of the items reflecting the preferences of consumers. In addition, other elements matter to the common man besides consumption. Security of employment, the level of the safety net, the opportunities for advancement, and individual freedom are all important. The question of which system performs better for the common man is therefore complex.

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TABLE 1

ANNUAL GROWTH RATES OF CONSUMPTION PER CAPITA, INCLUDING COMMUNAL SERVICES

USSR		United States	
Years	Growth Rate[a]	Years	Growth Rate[a]
1928–1978	2.8	1869–1929	2.4
1928–1937	1.1	1929–1978	1.7
1950–1969	4.5	1950–1969	2.3
1970–1978	2.5	1970–1978	2.7

[a]In percent per annum.
SOURCE: Gregory and Stuart (1981, p. 360).

Pejovich's requirement of social validation of "choice sets" by the individuals involved means, however, that the only way we can know what system of property rights is preferred by the common man is by observing his voluntary choices. Given an opportunity to vote for the system they would prefer to live in, citizens could show us by their feet what their preferences are. Most likely many would prefer to take the risks, rewards, distributional system, freedoms, and ethical values associated with capitalism, while some would opt for the risks, rewards, and values of socialism. There is no way we can rank one community bundle as unequivocally superior in meeting the needs of the common man than another, as long as some citizens would voluntarily choose each.

Conclusion

The question at issue—the effect of property rights on the well-being of the common man—is a serious one. As Pejovich has shown in his discussion of Yugoslavia, the set of property rights is a continuum, so we need not and do not face an all-or-nothing choice.

The socialist economies of Eastern Europe have been hampered by *inadequate incentives* for entrepreneurship, *insufficient penalties* for poor choice, and the *absence of mechanisms* for social valuations of the choices of the leadership.

The real issues are: What costs do we pay in terms of entrepreneurship and social validation foregone and individual liberty lost for establishing a system with greater ethical appeal in terms of equality, full employment and security, and possibly macroeconomic stability (Kornai 1980)? If wealth were equally distributed, individuals could join together freely in workingmen's associations, as Proudhon suggested over a century ago. Then we could have the

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benefits of maximally effective entrepreneurship, collaboration in the workplace, and social validation of resource allocation on the market. But even if we start out with equality, the consequences of a market mechanism under uncertainty is an income distribution that many find random, unjust, and unacceptable in its unregulated form. The issue is not whether entrepreneurial incentives and social validation are desirable, but what is the cost. If we really want to understand the merits of plan and market—the polar cases founded on different dispersions of property rights—it seems to me that these are the questions we need to address.

At the theoretical level we need to be aware of the dangers of allowing untested and unstated assumptions to enter and to invalidate our arguments about the relationship between property rights and performance. We must eschew reaching conclusions about social ranking not consistent with the framework of social validation. At the empirical level we need to identify more carefully the performance associated with different types of property rights and to examine in a more open-minded fashion the property rights associated with successful, nontraditional systems. Otherwise we can find as "answers" only the beliefs we started out with.

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TWO VARIETIES OF INDUSTRIAL POLICY: A CRITIQUE

Don Lavoie

Introduction

Should a special agency be established and invested with the responsibility of explicitly guiding our nation's industrial development? Clearly the growth rate of our economy is not what it used to be. Can we afford to let international economic changes continue to disrupt our economy without entrusting a national agency with the task of easing whatever transformations seem necessary? Must we stand idly by and permit the burdens of such changes to be borne haphazardly and unequally, or should we not consciously decide such matters? Must we not deliberately take on the task of "reindustrializing" the American economy, of getting our economy moving again?

With such questions, contemporary advocates of "industrial policy" are raising issues which have a rich tradition of scholarly debate in the field of comparative economic systems. My aim is not to elaborate on those academic debates but to apply what I take to be their chief "lessons" to the proposals of two of the most prominent advocates of industrial policy, Felix G. Rohatyn, Wall Street financier and head of New York's Municipal Assistance Corporation ("Big MAC"), and Robert B. Reich of Harvard's John F. Kennedy School of Government. I will try to show that the apparent reasonableness of the questions posed in the opening paragraph disguises a serious misunderstanding by industrial policy advocates of the way in which a modern economy works. In particular, I will contend that both the differences between these two advocates of industrial policy and

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their underlying similarities reveal basic flaws in the whole idea of industrial policy.

The classic debates I have in mind were over the political and economic difficulties of centralized economic planning. Advocates of industrial policy are quick to point out that their aims are much less ambitious. To avoid—or at least delay—offending my opponents, I will refrain from labeling their policies "national economic planning," even though I see little substantive difference between industrial policy and the policies that more forthright advocates like Wassily Leontief call planning.

As used today the term "industrial policy" usually implies the idea of establishing a new Reconstruction Finance Corporation (RFC); that is, a special agency of the national government with the responsibility for guiding investment in directions different from those they otherwise would take. This investment-guiding agency might be modeled on America's earlier RFC—an idea favored by Rohatyn—or on Japan's Ministry of International Trade and Industry (MITI)—an idea supported by Reich. For theoretical as well as historical reasons, I will argue that we should adamantly oppose the establishment of any such agency in the American economy. A new RFC, whether of the Rohatyn or the Reich variety, would be politically dangerous and economically burdensome for the same reasons centralized planning was shown to be inefficient during the classic debates over planning.

There are two difficulties identified by the earlier debates over central planning which apply to industrial policy. First, there is *the political problem:* The danger that this new RFC could become a powerful dictatorial weapon. Can the proposed agency be expected even to *try* to do the bidding of the wisest and most benevolent advisors?[1] Second, there is *the knowledge problem:* Those who direct the new RFC will necessarily lack the knowledge to carry out their own goal of reindustrializing our economy. The question here is whether an investment-guiding agency that is (somehow) controlled even by the most benevolent and wise directors would be wise enough to be able to acomplish more good for the economy than damage.[2]

[1]The classic statement of the political problem is F. A. Hayek's *The Road to Serfdom* (1944).

[2]The knowledge problem was called the "calculation problem" in the economists' debates of the 1920s and 1930s, and its chief propounders were Ludwig von Mises (1935) and F. A. Hayek (1948). I have tried to elaborate on the meaning and significance of this controversy in my forthcoming book (1985). See also Vaughn (1980), Hoff (1981), and Lavoie (1981).

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Reich and Rohatyn readily admit the potential danger of the political problem but offer precisely opposite "solutions," neither of which is terribly convincing. The two authors, however, seem unaware of the knowledge problem, or even the possibility of such a problem, and therefore offer no clues for its solution.

The knowledge problem alerts us to the fact that the competitive market process achieves a higher degree of "intelligence" in spontaneously directing industrial change than is possible for any single agency within the economic system. In effect, decentralized competitive processes, although they possess no single "director," exhibit a sort of "social intelligence" which exceeds the "individual intelligence" that is attainable by any single agency.

The competitive process is able to achieve this by means of the price system. It is the continuously changing configuration of relative prices that provides signals to the disparate decision makers, who calculate profit and loss in terms of these prices. Individuals who discover more efficient ways of using society's resources are rewarded with profits. In this manner a high degree of precision is possible when choosing among an array of complex production plans. The knowledge generated by the various competitive "tugs" exerted by market participants on relative prices is revealed only in profit/loss accounting. Given the manner in which the market uses knowledge, the best any individual intelligence can ever do to enhance the flow of new investment is to *participate in* the social process, to try to tug prices in the desired directions and see whether profit or loss is forthcoming.

The term "social intelligence" is of course only a metaphor. All real intelligence lies within individual human minds. Nevertheless, the only way human intelligence has ever been exercised is in *social* processes of interaction with other minds, whether in the process of communicating in a language, debating in a scholarly scientific journal, or competing for profit in an economy. For our purpose the issue of "social intelligence" involves the extent to which individual knowledge can be imparted to the price system.

The extent to which any particular market participant can affect prices derives from his superior knowledge of localized economic circumstances. He contributes his knowledge to that contained in the price system as a whole and is rewarded for this contribution by earning a profit. On the other hand, if his "tug" is misinformed, its influence will be eroded by incurring a loss. But when the strength of a market participant's effect on prices derives merely from the fact that he receives special attention from an RFC-type agency

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attempting to "make industrial policy," the whole knowledge dispersal process is undermined.

The knowledge problem constitutes a challenge to advocates of industrial policy which could be put in the form of a question: "If you are so knowledgeable about investing, why not just go out and make a profit?" This question may sound rude and irrelevant, but it strikes at the heart of the difficulty. Both Reich and Rohatyn rest their case on their own expertise. They are touted by their supporters as "financial wizards" who *know* how to guide investment. But society can more readily benefit from the superior knowledge of any individual when he uses it *in* the competitive process. If Reich and Rohatyn are the financial wizards they claim, then society will benefit if they gain market power—not by forcibly channeling market forces in the desired directions, but by profiting from their own superior investment decisions.

Reich and Rohatyn have very different ideas about which industries ought to be helped and how; thus they cannot *both* know the best way to guide investment. The only proven testing ground for their competing views of industrial policy is a free and open competition for profit. In short, the competitive market implicitly compels the "smart" investor to put his money where his mouth is, but Rohatyn and Reich want these battles to be fought *explicitly* within the federal government. It is the main conclusion of the knowledge problem argument, however, that there are no rational grounds upon which Reich could convince Rohatyn or vice versa. There is no way an individual can know what specific industrial policy the government ought to follow. The task of guiding industrial development in the modern economy is too complex to be made explicitly; that is, by individual intelligence. Instead, it must be accomplished tacitly by the interplay of rivalrous competition in the price system; that is, by "social intelligence." As a result the battles over specific industrial policies are sure to be fought with weapons other than those of reasoned debate.

The knowledge problem and the political problem are therefore intertwined. The knowledge problem says that neither Reich nor Rohatyn (nor other proponents of industrial policy) can possibly know which industries will ultimately enhance industrial growth. The political problem says that with so much power concentrated in a single agency and since the case for any particular use of this power lies beyond the capacity of human reason to fully establish, battles are likely to be won by brute force rather than by careful debate.

The next section of this paper examines Rohatyn's and Reich's proposals for reindustrializing America in light of the knowledge

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problem and the political problem. I then consider their historical arguments, including Rohatyn's own success story in New York City and the one he tells about the old RFC of the 1930s, as well as Reich's attribution of Japan's postwar success to MITI.

Reindustrialization and the "Structure" Metaphor

The word "reindustrialization" has become the political slogan of the season precisely because it is vague enough to include everyone's program and innocuous enough to be negotiable as ideological currency. Everybody favors revitalizing and modernizing American industry. Reindustrialization refers to a fairly uncontroversial *goal* of national policy, achieving a second industrial revolution, while leaving the more contentious *means* unspecified. As a result confusion reigns about what reindustrialization implies in terms of any concrete measures for stimulating the economy. The term spans the spectrum, from radical leftists to establishment liberals and even populist conservatives. In fact one leftist writer (Lens 1980, p. 44) attributes its origin to right-wing congressman Jack Kemp, and condemns it as fascism, while others on the extreme left have tried to appropriate the slogan for themselves (Bluestone and Harrison 1982).[3]

Despite the wide range of political thinkers associated with reindustrialization, an important subset seems to be emerging, distinguishable from both welfare-state liberals and conservatives. The emerging perspective has been singled out by one enthusiastic writer as a "new economics" that is "at the frontiers of economic thinking" in much the same way Keynes became in the 1930s. It has even been christened with another, almost equally ambiguous, name: "structuralism."[4]

While the common grounds discernable among this diverse group are much too nebulous to earn it designation as an economic school of thought, the term "structuralism" captures a key attitude typical

[3]Lens and Bluestone and Harrison all consider Rohatyn a politically dangerous corporativist or fascist (understandably in my view) and yet Bluestone and Harrison refer to their own program as "reindustrialization with a human face," a throwback to the phrase popular a decade ago among Eurocommunists and Eastern European dissidents who hoped to create a "socialism with a human face." One may legitimately wonder, however, whether putting a "human face" on what are essentially socialist or fascist policies can somehow transform them from reactionary into progressive ones or whether it succeeds only in disguising their true nature.

[4]Besides Rohatyn and Reich, Karen W. Arenson (1982, section 3, pp. 1, 24) includes rather broadly under this term both Paul Samuelson, an old-time establishment Keynesian, and Barry Bluestone and Bennett Harrison (1982) on the radical left. Among the writers associated with this perspective should be included Bowles, Gordon, and Weisskopf (1983), and Muller (1980).

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of most advocates of reindustrialization. The extended use of a civil engineering metaphor typifies this view: The economy is like a great structure, a building in which certain stories (industries or regions) are the foundations which must remain firm to support the whole edifice of the relatively superficial upper stories. Industrial policy is advocated to shore up the weakening beams and supports upon which the survival of the rest of the structure depends. A new RFC is promoted as a sort of crack team of specialists, responsible for identifying any structural weaknesses in the economy and for patching them up with federally guaranteed loans, grants, and other forms of aid.

As long as we remain on this vague and metaphorical level, there is complete agreement between Reich and Rohatyn; but the RFC agencies envisaged by these two advocates of industrial policy are starkly different in two respects. Rohatyn prefers an "insulated" agency funneling aid to sunset industries, while Reich advocates an "open" agency directing aid to sunrise industries.

Rohatyn proposes protecting government experts from the fray of political battles by isolating them from democratic pressures. He complains there are already too many democratic checks on the discretion of our leaders, and he favors constitutional change "so that a president with a real vision of the future will be able to put his program through." Rohatyn admits this change would be "obviously a risk for democracy," but apparently it is one he is willing to take (1980b, p. 24). His new RFC would be "publicly accountable, but sheltered from political pressures" (1982b, p. 80), and Rohatyn believes that in this way "fair" agreements can be negotiated.

In contrast, Reich would pursue consensus by further opening up the process by establishing a "national bargaining arena" where proposals can be "debated in full view [of those] groups on whom their costs would fall" (1983, p. 276). Reich's argument that Rohatyn's closed RFC would represent a dangerous concentration of power is convincing. But so is Rohatyn's claim that Reich's open RFC would become a politicized chaos of special interest dealings. Neither offers any compelling reasons why closing or opening the new RFC to direct political scrutiny would reduce the likelihood of the new agency's exploitation by special interests.

Rohatyn's emphasis on salvaging the declining older industries is also in direct contrast to Reich's emphasis on promoting newer, high tech, or as he prefers to call them, "flexible-system" enterprises (1983, pp. 13, 127–39). Rohatyn wants to channel investment funds toward steel plants, highways, and subway systems, while Reich wants to promote those industries which are, according to his own

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expectations, destined to be the technologies of the future. As Reich (1983, p. 13) puts it:

> The industries in which the United States can retain a competitive edge will be based not on huge volume and standardization, but on producing relatively smaller batches of more specialized, higher-valued products—goods that are precision-engineered, that are custom-tailored to serve individual markets, or that embody rapidly evolving technologies. Such products will be found in high-value segments of more traditional industries (specialty steel and chemicals, computer-controlled machine tools, advanced automobile components) as well as in new high-technology industries (semiconductors, fiber optics, lasers, biotechnology, and robotics).[5]

But these proponents of reindustrialization fully concur that the economy is dangerously "out of control" and therefore in need of concerted government action. Rohatyn (1980a) begins one of his articles with these words: "It has been apparent for some time that our economy was out of control . . ." (p. 13). Reich (1983) begins his latest book by declaring that "since the late 1960s America's economy has been slowly unraveling" (p. 3); he later warns ominously that "the U.S. economy is grinding to a slow, painful halt" (p. 134). To meet the challenge of international competitors such as Japan and West Germany, says Reich, "requires far-reaching economic and social changes"; but we are "not organized for changes of this magnitude" (p. 14). Hence an institution for "orchestrating adjustment" is needed as well as "more strategic policies to shift citizens to higher-valued production"; that is, we need to gain control over the "unraveling" American economy (p. 267).[6]

Common to advocates of industrial policy is their use of the structure metaphor to promote the salvaging of certain industries designated as basic. Rohatyn remarks that services are a "weak basis for the economy" and are somehow "debilitating, both in . . . substance and in . . . symbolism" (in Alpern 1981, p. 29). The kinds of industries that Rohatyn views as more appropriate to our country's symbolic self-image and which constitute the necessary foundation of the industrial structure are the manufacturing sectors, especially the heavy

[5]Reich's numerous discussions of the kinds of industries he sees dominating the future have the ring of an advertisement for a Wall Street investment house. We must keep in mind, however, that his intention is not to *persuade* people to invest in these industries.

[6]See also Magaziner and Reich (1983, p. 258), who contend that America's economic problems are attributable to "the absence of any single agency or office with overall responsibility for monitoring changes in world markets or in the competitiveness of American industry, or for easing the adjustment of the domestic economy to these changes."

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industries such as steel and cars. Rohatyn views it as a national crisis that "McDonald's hamburger chain employs more people than U. S. Steel" and concludes that a massive effort is needed to rescue his favored industries (Rohatyn 1981a, p. 16).[7]

Reich (1983) agrees that "the nation cannot rely on services" because these "depend on the vigor of its future manufacturing base" (p. 132). The fact that the "nations of Western Europe and Japan have been selling America more manufactured goods than it has been selling back to them" is taken as evidence of the decline of this country's economy. The crisis is the fact that "America's basic steel, textile, automobile, consumer electronics, rubber, and petrochemical industries are becoming uncompetitive in the world" (p. 126).[8]

Despite frequent insinuations that the proper image of a proud nation should depend on tough and physical things such as steel plate and truck chassis rather than soft and gushy things such as soybeans and hamburgers, there is nothing substantive to suggest what is so shameful about this state of affairs. For over 200 years economists have argued that the wisest course for any nation is to permit free trade. Each country then can produce those goods for which it has a comparative advantage and exchange them for the goods that are more efficiently produced by others. Only in this way can we generate the maximum quantity of all the goods we would like to consume. While it might damage some people's sense of patriotism to face the fact that America exports agricultural products to Japan in exchange for manufacturing goods, surely this is a development with which mature adults can learn to cope. It seems that our primary concern should be whether we *have* jobs and what quality of life these jobs allow us to afford, not whether the goods we happen to be most efficient at producing promote the symbolic image we have of ourselves.

[7]On Rohatyn's propensity to see "serious repercussions" and national crises everywhere, see the insightful review of Rohatyn's *The Twenty-Year Century* (1984) by Michael Kinsley (1984, p. 27).

[8]Similar symbolic preferences for certain "basic" (one could almost say "macho") industries are to be found among most other proponents of industrial policy as well. Bluestone and Harrison (1982, p. 5) find it "shocking" that

> in terms of dollar value, the number one Japanese product sold to America was passenger motor vehicles, followed by iron and steel plates, truck and tractor chassis, radios, motorbikes, and audio and video tape recorders. In contrast, America's top seven exports to Japan, in order of dollar value, were soybeans, corn, fir logs, hemlock logs, coal, wheat and cotton. The . . . United States has been reduced to an agricultural nation trying desperately to compete with the manufacturer of the world's most sophisticated capital and consumer goods.

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Rohatyn and Reich do suggest that there are substantive as well as symbolic reasons to resist the decline of the basic industries, but offer only occasional clues as to what these reasons are.[9] They each try to argue that we should salvage some industries because they constitute the main source of demand for other industries.[10] Such connections between sectors can be multiplied at will and both authors, of course, differ with respect to which industries should be helped. For example much of the steel the United States does produce competitively is the type needed for high-tech industries, such as microprocessors. Hence Reich argues that granting cheap credit to the latter will help the former, while Rohatyn claims that aiding the former will help promote the latter. But the relationships between the health of different sectors in a modern economy are so intricate and complex that it is highly implausible that any single agency could take them all into account.

Reich agrees with Rohatyn that the uncontrolled decline of "basic" industries constitutes the main problem which industrial policy is supposed to solve, but he disagrees about how to respond to this decline. While Rohatyn wants to retard structural change, Reich wants to hasten it. Rohatyn is for shoring up the old structures, Reich for "restructuring" them to adjust to new realities. Reich believes the national bargaining arena should "negotiate a package of public adjustment assistance designed explicitly to buttress their most competitive operations, retrain their work force, and shift other resources to more profitable uses" (1983, p. 276), but he is quick to assure us, "This does not mean that industrialized countries must abandon their older industries, like steel, chemicals, textiles, and automobiles," which are "the gateways through which new products and processes emerge" (p. 130). Nor, he says, should these industries be supported as they are now through government subsidies. Rather we should

[9]Rohatyn occasionally suggests that the real reason for the priority of structural industries is national defense, but this argument carries little weight. It is not only things like steel and truck parts that foreign governments could withhold to hurt our military production. In a world that is increasingly interdependent it is difficult to think of any products, other than nonessential consumer items, the withholding of which could not somehow, directly or indirectly, harm the interests of national security. To defend itself from such potential blackmail the United States would have to become virtually autarkic. But to even approach that condition would reduce our productivity so drastically as to genuinely endanger our national defense.

[10]Rohatyn (1982b, p. 80) points out that "the auto industry is one of the largest customers of microprocessors as well as of industrial robots and many other high-technology products." Hence he argues that if we are to promote high-tech industries, we must first save the so-called basic industries. Reich (1983, p. 132) similarly argues that since so much of the service sector is "directly linked to the manufacturing base of the country," it "surely will diminish as merchandise trade declines."

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"restructure them toward higher valued and technologically more sophisticated businesses."[11]

All of this propping up and restructuring, of course, is going to cost a lot of money. Both Rohatyn and Reich acknowledge this and favor increased taxes on consumption to defray the costs of reindustrializing. They take pride in the fact that, unlike the welfare-state liberalism of the 1960s which made glowing promises of benefits without regard to costs, in the 1980s they *stress* the costs. Rohatyn and Reich remind us, time and time again, that to reawaken our sluggish industrial system real sacrifices will be necessary. The recognition of scarcity, of the fact that every course of action entails the foregoing of other potential courses of action, is, indeed among the most important principles of economics. But, after all, welfare liberals used to talk about sacrifice too. It is hardly a fundamental departure from the old policies if Reich and Rohatyn merely have projections that are less optimistic or if their theme tends to be one of equalizing burdens rather than of spreading unlimited wealth.[12]

The structuralists present their program as if it represented a sharp departure from the kinds of Keynesian/welfare-state policies that have been practiced over the past few decades. Rohatyn, for example, declares that what the economy needs is not the "continued application of Band-Aids" but rather a dose of "strong medicine." Reich agrees with Rohatyn that the traditional tools of Keynesian macroeconomic policy are "too broad and too blunt" and that we are therefore "beyond economic 'fine tuning.' "[13]

Upon closer examination, however, the structuralists offer nothing but old fine-tuning policies after all. Their proposals sound like the same old band-aids: increased taxes, runaway money supply and inflation, skyrocketing government expenditure and indebtedness, and more government domination of the economy.

The proponents of reindustrialization are no more sensitive to the genuinely democratic tax revolt than were the welfare-state liberals; they just favor increasing *different* taxes. Reindustrialization proponents often advocate opening up and creating new tax loopholes and using tax incentives as one of the main instruments of industrial

[11]Reich (1983, pp. 130, 178–79) seems to believe there is a fundamental distinction between the sort of restructuring he has in mind and the kind of government subsidies we now have.

[12]Rohatyn wants the new RFC to ensure "evenly distributed burdens" (1980b, p. 24) while Reich calls for the agency to arrive at "a fair sharing of the burdens and benefits of industrial change" (1983, p. 256).

[13]Rohatyn (1980a, p. 6) and Reich (1983, p. 202). See also Muller (1980, pp. 28–29).

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policy.[14] The tax revenues lost to these loopholes are to be more than made up for by imposing heavy taxes on consumption. Both the corporate taxes preferred by welfare-state liberals and the consumption taxes to which the structuralists are partial are likely, however, to be most heavily borne by some of the poorest and most overtaxed segments of society. Having discovered the damage government has caused the economy by stifling investment with taxes on capital gains and profits, most structuralists want to impose excise taxes and stifle consumption instead.[15]

While paying lip service to the need to bring government spending under control, the structuralists, like their welfare-state precursors, promise massive spending projects that are guaranteed to increase total government expenditures dramatically.[16] Reich says, "We need a political revitalization," and envies West Germany, France, and Japan, where "traditions of legitimate government involvement in orchestrating economic change were firmly established" and where there are "more government-sponsored training and retraining, more generous unemployment assistance, and health benefits that are distributed more widely." Rohatyn talks casually about spending a trillion dollars on rejuvenating the country's physical plant.[17] And despite their "age of limits" rhetoric, both are as prone to ambitious, visionary government-spending agendas as the welfare-state liberals, as is revealed in the grandiose titles of their latest books: *The Twenty-Year Century: Essays on Economics and Public Policy* and *The Next American Frontier.*

[14]Amitai Etzioni (1983, pp. 317–41) relies primarily on tax incentives as the mechanism for his "semi-targeted" planning. Rohatyn (1981a, p. 14) is particularly fond of federal "programs for incentives for local tax reductions as a way to give stimulus to areas suffering the greatest economic hardship." While I agree with the general policy direction of reducing taxes, the basic knowledge problem arguments apply just as much to governmental attempts to steer the economy through *differential* taxation as they do to the use of other policy tools.

[15]See Etzioni (1983, p. 317), Reich (1983, p. 242), and Rohatyn (1982b, p. 74).

[16]Rohatyn (1982b, p. 80), for example, admits that "slowdowns in the growth of Social Security and healthcare costs are absolutely essential" if they are not to end up completely bankrupting the federal government. He criticizes Reagan's modest attempts to cut back on welfare programs not because he finds their operation actually to *be* fair, but on the grounds that "a democracy, to survive, must at the very least appear to be fair" and that "this is no longer the case in America" (1982b, p. 90). Presumably were Rohatyn in charge he would keep up appearances of this kind.

[17]Reich (1983, p. 275; pp. 14–15), Rohatyn (1982b, p. 72). Under the Carter administration Rohatyn (1980b, p. 23) was saying that part of his gas tax "should finance tax cuts that will lead to increased investment and an increase in military spending." Now that Reagan has promised us this program Rohatyn is saying things like "our defense program cannot be immune from . . . retrenchment" (1982b, p. 74).

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Rohatyn likes to joke that Reaganomics is "Keynes in drag," a program dressed up as fiscally responsible but underneath a prescription for deficits caused by tax cuts instead of by spending.[18] But in Rohatyn's own policies it is hard to see how Keynesianism has been transcended. Unwilling to challenge either defense or nondefense spending in any fundamental way, and prepared to add the immense cost of a new RFC to the already bloated budget, the structuralists cannot be expected to do much to reduce the federal deficit (Reich 1983, p. 120).[19] Rohatyn's solution to budgets that do not balance is to move expenses off budget; that is, pretend the deficit is not there, and then get somebody else to pick up the tab.

In addition Reich seems to believe that merely adding the adjective "explicit" to the intellectual arsenal of establishment liberalism is enough to turn old, unworkable policies into promising new ones: "An explicit regulatory policy would let Americans deal sensibly with the hard choices about the social costs of a given path of economic development—the concrete sacrifices of health, safety, and the environment that it would entail and upon whom the burdens would fall." Similarly Reich expects an "explicit training and retraining policy" to work where implicit training programs have failed. His repeated calls for replacing the implicit decision making of the market with explicit political decision making ignore the possibility of a limitation on the capacity of the individual human mind to

[18]Rohatyn frequently mistakes Reaganomics the rhetoric for Reaganomics the actual policies of the current administration when he describes the latter as "massive tax cuts and hugh increases in defense spending combined with tight money" or as "a huge budget cut coupled with a huge tax cut and restrictive monetary policy" (1981a, p. 14). In fact, federal spending is setting a 10-year record under Reagan, increasing in real terms by 8.7 percent from October 1981 to May 1982, while revenues from taxation rose in real terms in 1982 by 6.2 percent, the fastest increase since 1977. The "tight" money supply (M2) grew at an annual rate of 9.7 percent during the third quarter of 1982. The deficit under Reagan will be large indeed, but its cause is not tax cuts but the more familiar problem of runaway spending. What we have here is not "Keynes in drag" at all. We still have Keynes.

[19]The *Business Week* (1980, p. 27) issue on reindustrialization suggests that the federal budget be divided into two parts, a current accounts budget, which "should show a substantial surplus," and a reindustrialization budget, which "would have to run a large deficit for some time." Thus other governmental projects will have to tighten their belts, while the part that is needed "to help rebuild the eroded capital base" should not be "distorted by efforts to create the illusion that income will match outgo immediately." Rohatyn (1981b) insists that running his new RFC with "lending capacity of $25 billion to $30 billion, mostly provided by government-guaranteed bonds" would have only "limited impact on the federal budget," but if its operation is anything like that of its namesake we can expect this to directly cost something on the order of $10 billion for every $30 billion it lends out, not counting its crowding-out effects on the capital markets.

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articulate all the information that is used by the competitive discovery process. Reich simply assumes that anything the market does implicitly can be done as well by explicit government policy. Yet the central argument of the knowledge problem is precisely that the market system's ability to generate as much wealth as it does is primarily due to the fact that it can make use of tacit knowledge in a way that Reich's explicit politics cannot. Reich asserts that questions such as where the burdens of any given regulation will fall are unknown only because Americans are too secretive or are unwilling to face up to the "hard choices" we confront. That such issues might *have* to be decided implicitly—because the remote effects of policies are not ascertainable in advance—is a possibility he does not seem to have entertained.

In short, the advocates of reindustrialization seem to be as certain to increase the burdens of deficits and inflation as were the welfare-state liberals. Reich's only contribution to the failed incomes policies of the past is that he would make them "explicit" so that the government can make "aboveboard choices about how the burden of fighting inflation should be allocated" (Reich 1983, p. 274).[20] And Rohatyn repeatedly calls for a renewed bout of credit expansion by the Fed to reduce unemployment (at least temporarily) and to rejuvenate the housing and construction industries with lower interest rates.[21] Like

[20]Apparently it has not occurred to Reich that the way inflation works makes its redistributionary effects far too complicated to be sorted out. Those who get the newly created money relatively sooner benefit at the expense of those who face higher costs before they receive inflated incomes. The only way to allocate these burdens fairly would be to trace the detailed flow of money expenditures throughout the whole economy. But if that were possible we could dispense with the market altogether and adopt comprehensive central planning.

[21]Rohatyn (1982a, p. 7) advocates the creation of "sizable new credits from the banking system" in addition to debt extensions and moratoriums in order to shore up our weakening financial structures. He says that "we can have no real growth until our interest rate structure is lowered" (1980b, p. 23) and thus considers it "our most urgent national objective" to achieve "the reduction of unemployment through high economic growth rates and low interest rates." This, he realizes, requires "a commitment on the part of the Federal Reserve to accelerate its downward pressure on interest rates" (1982b, p. 74), or in other words vigorous monetary expansion to artifically lower the price of credit.

It has been precisely this policy of credit expansion which Hayek's work in monetary theory (for example, 1931; 1933; 1939) has shown leads to both inflation *and* unemployment. Although the immediate effect of lowering interest rates is stimulative, the extra investments this policy encourages are not coordinated with genuine consumer demand, but rather are dependent on further injections of money. When the credit expansion is reduced in order to fight the inflation this policy created in the first place, the investments that had been artifically stimulated are suddenly revealed to be unprofitable and a recession results.

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proponents of the welfare state, Rohatyn (1982b, p. 90) admits his ambitious spending programs run the risk of inflation, and so half-heartedly suggests that (discredited) wage and price controls could be resorted to as an inflation-fighting policy.

The advocates of reindustrialization still suffer from the crucial economic error of welfare-state liberalism. They both incorrectly presume the institution of government can possess the intellectual resources necessary to *effectively* redirect investment decisions away from the direction indicated by spontaneous market forces. That is, their attempts to "guide" production toward some industries (whether sunrise or sunset) and away from others (specified or not) will result not in a simple *transfer* of socially valuable resources but in a substantial *reduction* of them.

In a competitive capital market, entrepreneurs have to compete with one another to discover profitable projects in order to secure future command over more funds. To the extent that government agencies disperse favors in the form of cheap credits, the competitive discovery process is subverted and politically favored projects succeed at the expense of others which may be more economically efficient. The microprocessor and steel industries, as well as the economy as a whole, would be far healthier if we permitted them to compete fairly for investible funds rather than "rig the game" of the competitive process by providing cheap credit to some competitors at the (hidden) expense of others.

The only way we can know on which lines of production to concentrate and to what extent is by observing the outcome of market rivalry. Whether we are squandering resources by over- or under-investing in microprocessors or steel can be revealed only by the message contained in the relative profitability of rival firms in these industries. But this is precisely the information we garble when we channel money toward one or another of the contenders. Deprived of its elimination process, the market could no longer serve as a method for discovering better and eliminating worse production techniques. Without the necessity of responding to consumers' wants or needs, businesses would not withdraw from unprofitable avenues of production. One need not be a crude Social Darwinist to understand that we could no more expect the market process to function as the economy's coordination mechanism while simultaneously bailing out unresponsive firms than we could expect biological evolution to function without any species becoming extinct.

The only support industrial policy advocates offer for the claim that the particular industries called "basic" are necessary for the survival of other industries seems to be an excessively literal

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interpretation of their own metaphors. The term "industrial base" connotes some sort of foundation supporting the economy's structure (appropriately made of solid things like steel) without which the whole building will collapse. Thus we are told that we need to shore up our industrial base before we find it "coming apart at the seams," leading to a collapse of the whole structure.[22]

But articulating an analogy between an economy and a building does not constitute an explanation. There is no reason why the steel industry constitutes a more crucial linchpin of our economic structure than any other industry, whether its product is as tough as nails or as soft as software. There is no reason a country cannot find itself most prosperous by specializing in selling intangible services to other nations, in which case its industrial base would be invisible. To sustain an argument that an expensive rescue operation is needed to salvage certain selected industries, it is necessary to go beyond architectural analogies and specify why the overall economy can expect to benefit from such an operation.

The older structural industries are not all that Rohatyn wants to shore up through federal assistance. He also urges that large doses of money be offered to America's "older cities." Once again he uses a structure metaphor to carry most of the weight of his argument, but this time it is in terms of the so-called infrastructure which includes the nation's cities, harbors, and transportation systems. Rohatyn claims that we cannot afford to allow our cities to deteriorate; but he never explains why the rest of the country would benefit from accepting the burdens of the bad management of various mayors, just as he never explains why taxpayers should bear the losses that have resulted from the incorrect decisions of the managers of steel plants (Rohatyn 1980b, p. 23; 1982b, p. 80). If New York City's government cannot pay its bills, why should Idaho taxpayers be compelled to come to the rescue? As in the case of bailing out basic industries, would this not amount to a program for rewarding bankruptcy? Would this not be a policy virtually guaranteed to call forth a rash of defaults in order to win federal loans? If, as Rohatyn admits, the precarious financial situation of so many major metropolitan governments is a direct result

[22]Bluestone and Harrison (1982, p. 16) use the latter phrase. The phrase "shoring up the system" recurs throughout this literature. David L. Barnett (1980, p. 60) closes his article on the reindustrialization debate with the prediction that out of it "will come action that will shore up America's economic might." Etzioni (1983, pp. 190 and 313) talks about "steps needed to shore up the economy" and asserts that "all agree that the foundations of the American economy have weakened and need shoring up." Rohatyn (1982a, p. 3) refers to "a coordinated process that would shore up the system and avoid a crisis."

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of their irresponsibility, how can government-sponsored salvage operations be expected to make the recipients more responsible?

Rohatyn's response to such charges of rewarding failure is that his RFC would impose onerous austerity conditions on anyone who receives federal assistance, whether in city government or in basic industries (1982b, p. 82). Nobody will see these bailouts as coveted prizes because the conditions on the loans will be stringent enough to discourage further fiscal irresponsibility. This response requires the rather strong assumption that the financial experts within the RFC would be considerably more clever than those whom they are bailing out. We would have to assume that these experts could devise schemes which the managers of the recipient institutions could not devise, so cities or businesses could be saved without providing rewards which would attract others into the now lucrative business of going broke.

But perhaps the real reason Rohatyn wants to bail out older industries and cities is much more straightforward. He openly admits, "I like big cities.... Civilization grows there. Religion develops in open air, I suspect. But civilization—that is in the cities."[23] Such an argument takes us out of the realm of social science, however, and into the streets of political struggle. How would Rohatyn respond to a religious rural dweller who cares little about the so-called civilization of big cities and wants an RFC to bail out small farmers and bankrupt churches at the expense of steel companies and city dwellers? As long as we can find no plausible case for the special status of the older industries and cities—a case which can show that the health of other sectors and regions would unambiguously benefit from financing a massively expensive rescue operation—there is no reason why those who do not share Rohatyn's tastes should be expected to endorse his policy prescriptions.

There is no better illustration of the political problem—of the warfare that industrial policy will invariably ignite—than the divergence between its two leading proponents about which sectors ought to be supported. Although we have little assurance that there is any expenditure of which either Reich or Rohatyn would disapprove, it is evident that Reich cares little for Rohatyn's older cities, and that Rohatyn is relatively unimpressed by Reich's new-fangled technologies.

While Reich and others who clamor for reindustrialization largely agree with Rohatyn that basic manufacturing industries are among the structural supports of the economy, fewer would concur about

[23]Quoted by Alpern (1981, p. 26).

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the older cities. Rohatyn's third major category of potential recipients of RFC funding, the banks, is still less popular. But Rohatyn's logic in this case is no different than in the other two. Banks are described as "weakening financial structures" and pictured in the by-now-familiar metaphor as necessary supports for the rest of the economy. Needless to say, Rohatyn concludes that we must take "steps that would shore up the domestic banking system" because "the private banks, alone, cannot carry the burden." He proposes that "both the taxpayers and the bank's stockholders will have to assume a part" of the burden resulting from overextended credits to Third World countries "if the banking system is to be protected." Rohatyn proposes a sort of bankers' welfare system which would involve supplying "a safety net for our American banks" and "doubling the IMF's capacity to lend money" to help support "our" banks' shaky investments overseas. And, like his argument for saving the cities, Rohatyn apparently seeks to reward the banks for their financial irresponsibility simply because he likes them: "Our banking system is one of the most precious assets of our economy and of the free society itself."[24]

The real issue in all of these crises of weakening "structures" is the same. Whatever the underlying causes of the deterioration of basic industries, older cities, or overextended banks, their long-term salvation does not lie in propping them up with federal monies. Bailouts can only reward and perpetuate inefficient uses of scarce resources at the expense of more efficient ones. They can only obstruct the competitive discovery process on which the genuine health of our economy ultimately rests.

The idea of an economy's capital as a structure—in the sense of an interconnected, interdependent network of relationships among sectors—is an invaluable metaphor for understanding how productive processes are coordinated with one another. But unlike a physical structure such as a building, the economy's capital structure is continually changing. Its parts are forever readjusting on the basis of the profit signals without which producers of capital goods would be

[24]Rohatyn (1982b, p. 72; 1982a, pp. 7, 6, and 8). I am not minimizing the dangers involved in the U.S. banking system's shaky international commitments. The default of a couple of Third World countries could bring down several major banks and cause immense financial difficulties in this country if significant reforms to the banking system are not undertaken first. The issue is not how bad these banking problems are, but whether propping up the very institutions which brought about the problems and rewarding the very decision makers who got us into this danger is the best way to resolve them. The banking system is the oldest cartel in the United States and the most in need of fundamental reform in the direction of more competition, not, as Rohatyn would like, more government involvement. See Weber (1983).

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unable to guide their use in such a way as to best contribute to the future production of consumption goods. Thus a call for governmental restructuring or shoring up of this self-ordering system amounts to interference with the very mechanism that tends to keep the sectors of the capital structure integrated with one another.[25]

The fact that Reich wants to accelerate many of the very changes that Rohatyn wants to slow down does not make his policies any more compatible with the market mechanism. To favor "flexible-system production" is to desire an outcome, not to specify any means for its attainment. To propose that the new RFC *guide* market forces (whether this guidance is called accelerating or decelerating) is to presume that this agency can anticipate future developments better than the market can; it is to assume that the agency's individual intelligence exceeds the social intelligence of the competitive process. How will the agency know exactly which up-and-coming firms to direct funding toward? Whether resisting or promoting the market's structural changes, the advocates of reindustrialization must assume that the directors of the new RFC know enough to intelligently intervene in the market process.

The structuralists often seem unaware that progress requires abandoning less-effective modes of production precisely to release resources for more-effective ones. Rejuvenating the American economy cannot be accomplished without relying on the knowledge, supplied by competition, about which lines of production to discard as well as which to pursue. By taking their own metaphor too seriously, the structuralists presume that shoring up the economy is a task like that undertaken by a civil engineer who repairs the structural supports of a building; they treat a dynamic spontaneous order, which is sustained by the social intelligence generated by competitive processes, as if it were a single static project under the supervision of an individual intelligence.

[25]In their book on *The Deindustrialization of America* (1982, p. 208), Bluestone and Harrison reveal the essence of the structuralist position by obligingly taking it to its ridiculous extreme. They identify as one of the main causes of our economic malaise "the increase in the velocity of capital mobility." The problem, then, is alleged to be the mobility of investment per se, not just its withdrawal from basic industries or beloved cities and banks. Since capitalists are compelled by the profit motive to constantly look for ways to cut costs, they invariably can be found pulling out of less cost effective investments. They are therefore deindustrializing older facilities. The proposed solution to this "problem" is to pass plant-closing legislation to make it difficult for capital to move. This, of course, will mean that less and less of our nation's productive plant will operate cost effectively as time goes on and as economic circumstances continue to change. Taken to its logical conclusion, reindustrialization is a pathologically reactionary call for economic rigidity, for preventing rational adjustments to changing circumstances.

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The Expert Coordinators: Some Historical Lessons

The articles and books by Reich and Rohatyn would serve well as formal job applications for the position as head of a new RFC. Their works are filled with general statements about the need for "expert and courageous leaders," but it is not difficult to read "like me" between the lines. While the call for strong leadership plays a crucial role in their arguments for industrial policy, this emphasis contributes nothing to answering the knowledge problem and does little to dispel fears about the political problem. The responsibility of the "strong leader" will be to *coordinate* the actions of the rest of us. Significantly, while Reich and Rohatyn repeatedly use the verb "coordinate," it is always in its transitive form. Coordination, in their view, cannot occur spontaneously among interacting individuals but must be imposed by a coordinator on the coordinated.

Of course both these writers would deny they could become economic dictators. The new RFC would have a decision-making board which will "hammer out" compromises. Rohatyn wants closed hard-headed "bargaining" sessions to be staged among representatives of business, labor, and government and describes himself as an active negotiator by temperament. Reich points out that "much will depend on the quality of America's future political leadership" and that "we will need leaders who are not afraid to recognize frankly the political choices that are entailed in major economic change and who are willing to choreograph openly the bargaining about them." Despite Reich's democratic-sounding discussions of open arenas for bargaining and debate or Rohatyn's promises of fair negotiations, it is a peculiar bargain indeed that has to be choreographed by a courageous leader. And given the nature of the participants in these bargaining sessions (political representatives of special interests) and the sorts of issues being debated (who gets special benefits and who gets penalized), it is inevitable that any consensus reached must either stack the forces on one side among the contenders or leave the real victims out of the "arena" altogether.[26]

[26]Rohatyn (1982b, p. 82, p. 74), Reich (1983, pp. 14, 273, 275 and 276). It is worth noting that the original, idealistic aspirations for fascism in Italy were to set up the very same kind of bargaining arena for settling conflicts that Rohatyn and Reich now promote, and that there too we were promised a kind of choreographed bargaining process. See for example Luigi Villari's "The Economics of Fascism" (1932, pp. 98–9): "The National Council was created to coordinate all the productive forces of the nation. . . . The Council is further entrusted with the duty of coordinating the interests of the various branches of trade; this is a particularly important provision, and implies the settling of such conflicts as may arise, as for instance between agriculture and industry, or between two or more rival industries."

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Rohatyn places much of the burden of his argument for industrial policy on the issue of courageous leadership; for it was his own trumpeted "success" as chairman of the Municipal Assistance Corporation (MAC) in salvaging New York City that convinced him to attempt to "go national" and set up a bigger MAC for the whole country.[27] Rohatyn continuously reminds us how New York was saved through his expert guidance and that, since the nation's problems are similar, the answer must lie in putting a financial expert (like him) in charge of the nation's finances. Each of his several popular articles makes at least passing reference to his extensive financial experience both in business and in rescuing New York.[28] Hence it seems fair to ask just what did happen in New York. Do Rohatyn's efforts there inspire any confidence in his financial expertise and in the kinds of policies he wants to extrapolate for the nation?

The bankruptcy of the New York City government was preceded by a 10-year increase in borrowing for current expenses: from $26 million in 1965 to $724 million in 1975. During the same period the overall short-term debt rose from $250 million to over $4.5 billion. One of the biggest factors in this debt debacle was the mushrooming of off-budget enterprises (OBEs), quasi-private agencies whose borrowing could escape the constitutional limits placed on official government borrowing. The "courageous" (Rohatyn's word) solution that Governor Hugh Carey devised to solve this problem was the creation of even more OBEs. In particular, a state-level Municipal Assistance Corporation (led by Rohatyn) was authorized to issue an additional $10 billion in new bonds. These bonds, however, were sold only when the federal government agreed to offer over a billion dollars in loan guarantees and other forms of support. Rohatyn admits that "there is a real question whether the market can absorb the billions in New York-related securities," but says that this makes the argument for a new RFC more compelling. But he cannot have his cake and eat it too. Rohatyn cannot plead that the dire financial circumstances of New York City make an RFC necessary and then

[27]Rohatyn describes New York City's salvation as having "required the courageous political leadership of the governor" (1980b, p. 20), while the nation's problems will also "require inspired political leadership" (1980b, p. 22).

[28]See for example Rohatyn (1980b, p. 20), where the austerity measures he imposed on New York are declared to be "what saved the city," or Rohatyn (1981a, p. 16), where "cooperation among business, labor, and government coupled with a wage freeze, cost control, and sales tax revenues driven up by inflation," most of which were engineered by MAC, are credited with having "saved New York City."

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rest his case for the prospects of a successful RFC on the shining example of his rescue of New York City from its threat of bankruptcy.[29]

In other words Rohatyn was able to save New York City by spreading its burdens to state and national taxpayers. He advocates similar bailouts for other localities that try to live beyond their means. It was not some mysterious financial wizardry that worked its magic on New York City, or the much-vaunted austerity Rohatyn repeatedly insists he imposed on the unions, banks, and political institutions there.[30] It was, on the contrary, the rather pedestrian idea of letting someone else pay the bills. But there are no higher levels of government to pick up the tab for our national problems, though Rohatyn, if given the chance, would love to "go international" and ply his trade at the IMF.

If Rohatyn's success in New York City is less than inspiring as an example for the new RFC, what of the original RFC itself? The Reconstruction Finance Corporation is discussed in a favorable light by Rohatyn almost as often as his New York City story. The agency was established by Herbert Hoover in 1932, and over a period of 13 years it dispersed more than $35 billion.[31] As Rohatyn says, the RFC thereby "saved thousands of banks, railroads and businesses, financed public works and ultimately defense plants in World War II." Indeed, Rohatyn declares that, on top of bestowing these blessings on the economy, the original RFC even "returned a profit of $500 million to the taxpayers."[32]

This profit figure, however, was determined through an imaginative arithmetic manipulation (performed by none other than the head

[29]See Rohatyn (1981b). This account is taken from a more extensive examination of OBEs by Bennett and DiLorenzo (1982), especially chapter 5.

[30]McClelland and Magdovitz (1981) report that a private auditing firm found a deficit of over $700 million in 1978, two years after MAC's supposedly tough austerity measures were firmly in place. In spite of Rohatyn's frequent appeals to the need for honest accounting procedures, the city reported a *surplus* of $32 million in that year.

[31]This is the total amount Jesse H. Jones (1951, p. 3) says the RFC "loaned and spent, invested and gave away."

[32]Rohatyn (1982b, p. 80) must have gotten this bogus profit figure by reading Jones's book (1951, p. 4) in which the statement that all of the $10.5 billion used "in the struggle against the depression" (which was less than a third of the total money dispersed) was "returned to the Federal Treasury with approximately $500,000,000 profits, after paying the Corporation's operating expenses and a fair rate of interest on the money which it borrowed to finance this phase of its operations." On the same page, however, Jones refers to cancelled debts that turn this half a billion dollar profit into an $11.5 billion loss. Randall Rothenberg (1983, p. 44) makes a different but equally misleading statement in his article on reindustrialization when he remarks that the old RFC paid for itself because "when Congress closed its doors, the RFC returned $6 billion to the Treasury."

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of the RFC in his self-aggrandizing book about it) which manages to omit some $12 billion of RFC notes that Congress generously cancelled. If any private credit agency were to take this kind of beating on its loans, it would become the laughing stock of the financial world. The RFC, of course, was established to make what other credit institutions would consider high-risk investments; that is, to aid businesses that might well fail without its subsidized aid. The idea that it could turn a profit by adhering to a loan policy of propping up firms unable to get loans from the private credit market is simply ludicrous. The new RFC would necessitate, as the old one did, considerably increased taxes and a hefty dose of government borrowing to foot the bill.

If the consequences of paying these hidden costs are acknowledged, it is hard to credit the old RFC with having saved any businesses on net. How many firms were taxed out of operation or squeezed out of credit markets because of the generous loans of this agency? Investment funds simply cannot be created by government fiat; they can only be rearranged. Since the proposed RFC, like any single organization, is necessarily limited by the capacity of an individual intelligence and has no crystal ball to reveal where the best future investment possibilities lie, its activities are likely to divert capital from the politically inept but economically efficient (to whom the social intelligence of market processes would have channeled funds) to the politically adept and economically inefficient.

Thus the knowledge problem indicates that the task Rohatyn would like a new RFC to take on—rejuvenating America's industry as a whole—is beyond the powers of any such agency, and indeed that it would almost certainly reduce the nation's real wealth. The political problem, meanwhile, suggests that the RFC, in practice, is likely to permit the securing of special privileges by the politically powerful at the expense of society as a whole. Whereas the old RFC was a dismal failure at rejuvenating American industry, it was a stunning success as a dispenser of privileges to those with high political connections at the expense of those without. Houston millionaire Jesse Jones boasts that during his tenure at the RFC "there was not a single instance of fraud in the entire organization," but his book is one long list of favors, many of them, coincidentally, to friends and relatives of the heads of the RFC.[33] In other words the RFC's only success

[33]Jones (1951, p. 11). On the early history of the RFC see Rothbard (1975, pp. 261–65) and Zaid (1973). See also Grinder and Fairgate (1975).

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was in its role as what humorist Will Rogers called "the caviar of big business" (see Jones 1951, p. 5).

Reich's favorite model for emulation is Japan's MITI rather than America's earlier RFC, but he recognizes the close family resemblance among all such institutions and sees the RFC as an important experience. Through this experience, he says, government, business, and labor "learned to communicate and bargain smoothly, orchestrating decisions through their hierarchical control over vast reservoirs of complementary resources (Reich 1983, pp. 52–53).[34] Reich's "national bargaining arena" would differ from Rohatyn's RFC only on the particular industries he would like to support and the openness with which the agency would undertake its decisions. But Reich offers no more justification than Rohatyn for the belief that this investment-guiding agency will know how to repair the weakening industrial structures of our economy.

The Japanese miracle of rapid economic growth since World War II is attributed by Reich to the farsighted industrial policy of MITI. Unlike the story of the "rescue" of New York, there is no question that Japan's success is genuine. The nation's real GNP has grown from 21 trillion yen in FY 1951 to 191 trillion yen in FY 1980.[35] The only question concerns the extent to which we are justified in attributing this success to the positive actions of MITI.[36]

Reich paints MITI as an elite of experts who have consistently supported Japan's most successful industries. There have been so many winners like Sony and Honda, we are told, because MITI had the foresight to *pick* them. Having spent a lifetime studying the Japanese economy, however, G. C. Allen points out that MITI's record in selecting "sunrise" industries has been anything but awe inspiring. MITI bureaucrats were so unimpressed with the technological possibilities of the transistor in the 1950s that they tried for two years to prevent Sony from buying manufacturing rights from Western Electric. They tried to dissuade Japan's auto manufacturers from getting into the export market, then tried to force Japan's 10 auto firms to merge into two, Nissan and Toyota. Fortunately for the

[34]Reich (1983, p. 98) explicitly credits Hoover with having anticipated "the kind of government role in industrial development that Japan's MITI would undertake forty years later."

[35]These figures were computed in terms of market prices in calendar year 1975, as reported in the Comptroller General's report to the Joint Economic Committee of the U.S. Congress (1982, p. 2).

[36]Chalmers Johnson (1982) supplies an excellent historical survey of MITI and its antecedent institutions but he merely assumes that the Japanese miracle of the past three decades is due primarily to MITI's policies.

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Japanese economy all of this advice was ultimately ignored.[37] If MITI has made fewer of these sorts of errors than most other bureaucracies, it is only because they exert less power.

Thus if Japanese industrial policy is to be credited with an economic miracle, it would have to be on the grounds of how *little* it interfered with entrepreneurs' decisions relative to other industrialized countries. Reich credits the remarkable success of Japan's semiconductor industry to its government's industrial policy, but, in fact, the United States government has been spending 10 times as much as Japan on semiconductor research and development. The Japanese *economy* employs more people in R&D than Britain, France, and West Germany combined.[38] Government channeling of investment funds, the central policy goal of the reindustrializers, involves a relatively small proportion of Japan's capital formation.[39]

When the old bureaucratic class, the zaibatsu, was removed from power after the war, the productive forces of entrepreneurial competition were unleashed. Japanese government expenditure is still only about 25 percent of the GNP, compared to 35 percent in the United States and 44.5 percent in Britain (see Macrae 1980, p. 7). From 1951 to 1970 Japan's taxes fell slightly but steadily from over 22 percent of national income to under 19 percent, while taxes in most industrialized nations were rising.

Probably the single most significant factor in Japan's economic success has been its consistently high rate of savings. In 1980, for example, savings were over 19 percent of personal income. Here again it is the *lack* of government involvement which appears to be largely responsible. Depending on the kind of savings program, the first $13,600 or $22,600 of an individual's savings are tax exempt (Henderson 1983, p. 114). As a result, the reserves of capital available to Japanese entrepreneurs are estimated to be at least twice that available to American businesses (Gilder 1982, p. 15).

In short, while Reich is right that we can learn an important lesson from Japan, he has learned the wrong lesson. As Richard Casement (1982, p. 21) points out, by and large, "the market is king in Japan and companies respond rapidly to its changing fashions." What is

[37]See Allen (1981), Henderson (1983, p. 113), Gilder (1982, pp. 12–13), and Sunwall (1984).

[38]See Beckner (1983, p. 51) and Casement (1982, pp. 5 and 14).

[39]David Henderson (1983, p. 114) cites a study by Philip Trezise at The Brookings Institution which shows that the Japan Development Bank provides only about 1 percent of private, nonhousing capital formation.

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admirable about MITI is not what it has done or can do, but what it has not and cannot do.[40]

There is no substantive argument for industrial policy among the structuralists other than their belief in the expertise of people, presumably like Reich or Rohatyn. But their arguments and history, in fact, provide little to support a claim that the new RFC would be able to "orchestrate" clever solutions to the financial difficulties we face on the national level. Instead, we should expect solutions which offer generous rewards to those who run their businesses or governments into debt—policies which, in themselves, would require the federal government to increase taxes, inflation, or its own debt. Reich's policy of rewarding winners does not stem from any better conceptual foundation than does Rohatyn's of rewarding losers, and it is as sure to encourage a gross waste of scarce resources and to make a bad economic situation worse.

Notwithstanding the insistence by industrial policy advocates that one of the main purposes in establishing a new RFC is to explicitly resolve conflicts among special interests, they are actually holding out a new and very tempting prize over which divergent interests can struggle. The political problem indicates that the worst will likely arrive on top in these struggles. Reich and Rohatyn at least *try* to address this problem, however unsatisfactory their solutions may be. But they have nothing at all to say about the knowledge problem. Nowhere are we shown why we should expect any single agency's individual intelligence to exceed the social intelligence that results from the rivalrous nonpolitical competition among capitalists, entrepreneurs, and workers that takes place in the market. Yet without such a demonstration, the call for industrial policy amounts to nothing more than a plea for more of the same kinds of blind government intervention in the market that has brought us our current difficulties.

Conclusion

The noble-sounding aspiration of reindustrialization, implicit in the rhetorical questions of my opening paragraph, is to achieve control over the process of investment through a government agency rather than allowing the shape of capital investment to be determined by the turbulent, undesigned, and anonymous forces of supply and demand in competitive capital markets. The likely result of the plea for a new RFC is that the turbulence will remain—as indeed the current battles between various factions of industrial policy

[40]For an interesting discussion of the Japanese experience with "industrial policy" and the role of MITI, see Sakoh (1984).

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advocates already show—but that the rivalry will be fought with political weapons in addition to financial ones. The upshot will not be more control over investment by society at all. Indeed, the wastes involved in these political battles for government privilege will ensure that society as a whole will suffer. The only way for society as a whole to be served by the investment process is to relinquish all ambitions for "industrial policy"; that is, to abandon all current efforts to control these decisions by governmental agencies, and not to enhance and concentrate such efforts into one immensely powerful bureau.

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INDUSTRIAL POLICY IN HUNGARY: LESSONS FOR AMERICA

Josef C. Brada

Introduction

If we view industrial policy as the concentration of government attention and resources on industries regarded as deserving of special support or rapid development, then it is evident that East European leaders have pursued industrial policies since the end of World War II. Policymakers had very definite ideas about the restructuring of the market or quasi-market economies they inherited from previous regimes. Until at least the mid-1950s and, in several of the less-developed socialist countries, until many years later, the central authorities pressed for the priority growth of heavy industry, spearheaded by metallurgy and machine-building, and for systematic import substitution both in heavy and light industry.

In the 1960s, industrial policy began to achieve a greater focus, presumably as part of the shift from extensive growth to intensive growth. The German Democratic Republic was the first to propose a strategy for a "scientific revolution" in industry, according to which those products that were most likely to be carriers of technological progress—chiefly products of the electronics, precision, and optical industries—would be given special priority in the allocation of investment and research and development resources. "Structure-determining tasks" that focused on these priority sectors were directed centrally, while responsibility for other, less important products was

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delegated to ministries, associations *(Kombinaten)*, and enterprises (Granick 1975, pp. 146–7)). The idea of concentrating resources on technologically advanced products was also influential in other East European countries, although the means of implementing these policies varied from country to country in keeping with the growing diversity in national economic systems.

A new conception of an industrial policy of the Japanese style, aimed at developing branches or subbranches of industry capable of generating specialized exports that would be competitive in world or CMEA (Council for Mutual Economic Assistance) markets, emerged in Eastern Europe in the second half of the 1960s. This export-oriented strategy was somewhat like the notion of promoting technologically advanced products, but it assumed different forms and emphases in different countries.

In this paper we examine the experience of Hungary with the development and implementation of its industrial policy. Hungary is a particularly interesting case study for several reasons. First, industrial policy is particularly important for Hungary. It is a small country with few resources beyond bauxite and fertile soil. Thus, like Japan, it is highly dependent on foreign trade for its economic welfare. Second, Hungary has undertaken significant reforms in its economic system, moving from the *dirigisme* of Soviet-style central planning in the 1950s to the market-oriented reforms introduced by the New Economic Mechanism (NEM) of 1968 and the additional reforms implemented in the 1970s and 1980s. Finally, Hungary is interesting because it differs from other East European countries in that agriculture appears to be—if not a conscious element of industrial policy per se—at least a sector perceived to be progressive and important to Hungary's foreign trade performance.

Elements of Industrial Policy

Before we can examine Hungary's efforts at formulating and implementing an industrial policy aimed at developing competitive export industries, we require an analytical framework. An effective industrial policy would seem to consist of four elements: selecting industries for promotion; selecting markets; allocating resources; and achieving production and exports.

Selecting Industries for Promotion

Perhaps the most controversial aspect of industrial policy is whether the government is indeed better able to select the industrial sectors that ought to be promoted than is the market, and whether the pace

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at which government policy redeploys resources is more efficient than that of the market. For advanced countries industrial policy, to a great extent, must be based on forecasts of the future pattern of technological progress and structural change. For less-developed countries the technological choices are less difficult, but questions regarding the ability to absorb new technologies, to manage new industries, and the rate at which more advanced countries will yield their markets to new competitors create at least as much uncertainty.

A second difficulty in setting industrial policy is that the choice of sectors to be promoted is often not based on considerations of comparative advantage as prescribed by the factor endowments theory of Heckscher and Ohlin. Rather, new and nontraditional theories of comparative advantage are used to justify choices of sectors slated for promotion. Some of these new theories stress firm-specific sources of comparative advantage. Among these are economies of scale at the firm level. Thus government assistance in concentrating firms into large agglomerations, as well as promoting a high volume of sales, would be appropriate policies to capture such economies. The lumpiness of the capital stock in certain industries, coupled with an optimal firm size that preempts a large share of the existing and prospective market, is also a source of comparative advantage that can be promoted through government support. To the extent that research and development outlays appear especially risky to firms, and thus lead to a divergence between perceived private and social returns to research, the subsidization of research by the government can create a greater willingness on the part of firms to undertake innovative activities. Finally, firm-specific advantages can be based on elements of monopolistic competition where local firms compete with their foreign rivals on the basis of differentiated products or superior organization, both of which may be promoted by appropriate government policies. With the exception of economies of scale and optimal firm size, the creation of firm-specific sources of comparative advantage depends in large part on the willingness and ability of firms to respond to government policies and to the external environment. They must expand research outlays and make changes in their organization, methods of production, and output mix to produce the hoped-for competitive advantages.

Other bases for industrial policy are economywide. While factor endowments may be part of such broader considerations, they appear not to be uppermost in policymakers' minds. Rather, emphasis has been on the need to develop "structure determining" industries that will have technological externalities for other sectors of the economy that use the products of the favored sector. The promotion of the

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electronics, computer, chemical, and machinery industries' production of computers and robots, by both market and planned economies, is often justified on the basis of the "modernizing" effect of these industries' output on a wide range of user industries.[1] Another criterion not specific to the firm is the level of productivity and productivity growth in the sector to be promoted. Governments desiring to maximize the growth of output should seek to promote the movement of resources from sectors of low productivity or few prospects for productivity growth to those where productivity or the potential for future productivity growth are high.[2]

While theoretical underpinnings for these bases of comparative advantage have been proposed (see Krugman 1980), much skepticism remains about choices of industries that appear to be inconsistent with the traditional factor-proportions doctrine. Nevertheless the perception that industrialization, and indeed industrialization along a specific line, is necessary for national economic success clearly makes policies that bypass the implications of factor-endowments theory attractive to policymakers. Thus Japan, for example, embarked on an expansion of its steel, shipbuilding, automobile, and chemical industries at the close of World War II despite the fact that its factor endowment clearly suggested that Japan's comparative advantage lay in more labor-intensive industries (Reischauer 1964; OECD 1972).

Selecting Markets

In selecting the industries that are to receive government support, the characteristics of the production process are not the only criteria to consider. The government certainly ought to seek out industries where productivity and productivity growth are high, and where economies of scale will create the potential to preempt rivals from other nations. However, equally important are the demand-side characteristics of these industries. That is the income elasticity of new products ought to be high, as should the price elasticity of the market share of established products. Industries aimed at the leading edge of the product life cycle in advanced economies will benefit more from longer lives than industries geared to older products. For new products, as advanced-country markets become saturated, the markets of less-developed countries will begin to expand.

[1]That the level of sophistication of the computer industry has an important effect on other sectors is shown by the study of the Soviet machine tool sector in Amann, Cooper, and Davies (1977), where the capabilities of Soviet automated machine tools were found to be seriously limited by the shortcomings of the Soviet computer industry.

[2]This doctrine has East European roots, as it stems from the work of Manoilescu (1931), although it has since been taken over by a number of development economists.

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In the case of Japan, for example, the postwar decision to promote capital-intensive industries was as much influenced by their appealing supply-side characteristics as by the realization that, at the time decisions on industrial policy were made, the United States was the only large market open to Japanese exports. Thus the Japanese predilection toward sectors with high productivity growth was reinforced by the need to serve a large, sophisticated market with high income elasticity of demand for certain goods which are often produced under conditions of increasing returns to scale or by industries characterized by relatively uncompetitive price policies.

Allocating Resources

Even if the government is able to identify winners and losers, it faces the problem of reallocating resources from the latter to the former. Existing industries have a vested interest in remaining in existence, and both management and labor are likely to exert strong pressure to turn industrial policy into a policy of protecting declining industries (Reich 1982). Similarly representatives of industries viewing themselves as potential winners are likely to pressure government decision makers to make allocations favorable to them. Since existing industries are likely to have greater political leverage than nascent or nonexistent ones, the possibilities for developing industries ab ovo would appear to be questionable. Moreover, given the political demands of labor and management advocates from different sectors seeking access to the benefits of industrial programs, the government may be forced to spread the access to additional capital and labor among too many industries, thus precluding the possibilities of creating economies of scale and establishing comparative advantage for these industries.

Achieving Production and Exports

To the extent that the government is able to identify and to direct resources toward favored sectors, the possibility of a successful industrial policy exists. However, actual success will depend on effective production, so that economies of scale, potential productivity gains, and other sources of comparative advantage are realized. This requires appropriate management skills as well as the ability to create the necessary technology or to master technology imported from abroad. Finally, once produced, goods must be marketed effectively in the target countries.

Consequently it is evident that a successful industrial policy rests on a combination of political, technical, managerial, and business factors. The Hungarian experience has some lessons for market

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economies—even, as we hope to show, for the United States. These implications arise, in the main, not from similarities in circumstance and economic system but rather from differences in them. Only by seeing which experiences with industrial policy are common to market and planned, or large and small, economies can we gain some feeling for what pitfalls can be avoided by appropriate policies and what problems appear to be an inseparable part of industrial policy.

Hungarian Industrial Policy under Central Planning

The post–World War II Hungarian economic system was initially patterned on that of the Soviet Union. Resources were centrally allocated by means of plans expressed in physical terms, and enterprises were judged largely on their success in meeting physical output targets. In such a system planners would appear to have a great deal of power to shape industrial policy. Not only could they allocate labor and investment to priority sectors but, by means of production plans, they could influence the pattern of production and innovation at the enterprise level. Thus central planning, combined with the small size of the Hungarian economy, provided an opportunity for the development and implementation of an industrial policy "from the top down"; that is, a policy devised by and executed at the behest of the central authorities.

A survey of these early efforts at an industrial policy by Schweitzer (1980) demonstrates that an industrial policy planned and executed from the top down was subject to a number of difficulties. Before essaying some generalizations about the nature and source of these difficulties, we present a brief overview of the experiences of the favored sectors of industry that were singled out for special development.

Transportation Equipment

The first comprehensive effort to promote a sector of industry into the role of an important exporter involved the manufacture of diesel-powered railway cars. Based on some firm-specific advantages that had enabled Hungarian firms to export such cars in the prewar period, the government hoped to update production to service promising markets in the Soviet Union, other socialist countries, and in developing countries. The prewar technology had to be updated, however, largely by providing the cars with a newer, more powerful diesel engine. The design of such an engine, the provision of appropriate components and materials for its manufacture, and the ability of suppliers to develop new systems and subassemblies all proved

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inadequate. As a result the cars proved unreliable in service and exports were neither dynamic nor profitable.

Machine Tools

In the late 1950s Hungary attempted, within the framework of CMEA cooperation, to modernize and narrow the assortment of machine tools it produced. As with the railroad cars, reliance was placed on domestic research and development resources. As a result all the new machines were introduced well behind schedule, and some of the designs proved so unsatisfactory that a number of them were not put into production.

Precision and Electrical Engineering

A variety of precision engineering products, including medical instruments and automation and instrumentation equipment for oil and gas distribution pipelines, were promoted in the 1960s with a view toward developing exports to the Soviet Union. In neither case was Hungary able to generate the volume of exports anticipated, due to difficulties in updating product technology and because Soviet demand did not evolve as anticipated.

In telecommunications the need of the Soviet market for switching equipment was consistent with the technical capabilities of the Hungarian producers, but due to a lack of industrial infrastructure, economies of scale could not be captured in the production of components, and excessive reliance had to be placed on components imported from the West, rendering exports to the Soviet Union unprofitable.

Passenger Buses

Another attempt at developing transportation equipment into an export sector involved the production of passenger buses. As in the case of the railroad cars, the decision to develop the production of passenger buses was based on the demands of the Soviet market. The basis for the international competitiveness of the bus industry was to be a large (by world standards) volume of production and the attendant economies of scale.[3] However, given the large size of the project relative to the capacities of the Hungarian economy, a great degree of international subcontracting and technology transfer was necessary. The cooperation with suppliers of components from other CMEA countries was not satisfactory. Western technology was

[3]Schweitzer (1980, p. 333) reports that Hungarian production of buses was to exceed that of countries such as Poland, Italy, and Sweden and approach that of the Federal Republic of Germany. Hungary is now one of the four or five largest bus manufacturers in the world.

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obtained for the engine, gear boxes, and other systems, largely through the purchase of licenses. In addition components and materials were, and continue to be, imported from the West (Bauer and Soos 1979).

Evaluated in terms of growth of production and of exports, the Ikarus bus program appears to be an example of a successful industrial policy. As Table 1 shows, the output and export of buses have both grown at above-average rates. Moreover, what was originally viewed as a product intended exclusively for the socialist market has evolved into one that is also exported to the West.

TABLE 1

HUNGARIAN BUS PRODUCTION AND EXPORTS

	1960	1980
Buses Produced[a]	2,200	12,500
Buses Exported to Socialist Countries[a]	2,000	9,500
Buses Exported to Non-Socialist Countries[a]	100	2,500
Share in Industrial Production (%)	8	19
Share in Industrial Exports to Socialist Countries (%)	11	20
Share in Industrial Exports to Non-Socialist Countries (%)	1	4

[a]Approximate number

The expansions of production and exports are not the only criteria for evaluating the success of industrial policy. The economic return obtained for the resources invested in the favored sector must also be considered. Certainly Hungary has achieved a scale of bus production that should yield economies of scale. Admittedly there have been some difficulties in achieving efficient volumes of production for all components, but these difficulties do not appear sufficient to vitiate the economies of scale in assembly and in engine production implied by the current level of production.[4] On the negative side the buses use a comparatively large proportion of imports, in the form of Western licenses and components, for which hard currency must be

[4]For example economies of scale in engine production were to be gained by using the engine in a dumper. Unfortunately, as Schweitzer reports, the design of the dumper created serious problems and few were produced. Moreover, domestic needs for small buses and their nonavailability from other CMEA countries forced Ikarus to produce a wider array of models than originally planned.

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paid. The profitability of selling such hard-currency intensive products on the CMEA market for nonconvertible currencies is questionable. Interestingly the buses Ikarus exports to the West tend to use even more hard-currency inputs, lowering domestic value-added even further.

Overall, then, the implementation of an industrial policy from the top down was not especially successful. This lack of success does not appear to stem from the choice of products and sectors whose market prospects were not favorable. Rather, the failure of the projects is due to the inability of industrial units to implement the policies by developing and producing competitive products, and thus firm-specific competitive advantages, quickly enough. This failure at the enterprise level stems directly from the fact that central planners chose the priority projects without true knowledge of the basis of potential firm-specific sources of comparative advantage, and because their expectations of economies of scale were not realized due to the high degree of vertical integration of Hungarian industrial enterprises. Only in the case of Ikarus buses, where foreign technology and a good deal of international subcontracting was employed, has industrial policy produced potentially favorable results.

Hungarian Industrial Policy under the New Economic Mechanism

In 1968 the Hungarian system of economic planning was reformed, with directive planning in physical terms replaced by the so-called New Economic Mechanism (NEM). Given the uniqueness of NEM measures and the systemic barriers to an effective industrial policy evident during the pre-NEM period, it is worthwhile to examine NEM features relevant to industrial policy. The allocation of investment was to be decentralized, with the state retaining control over one-half of investment resources, and enterprises control over the other half. Enterprises were to be given greater powers to make production decisions as well, with profits and market prices guiding choices of outputs and inputs. Output targets were abolished and branch ministries were to seek economic outcomes, rather than to plan in detail the activities of subordinate enterprises. Finally, a functional exchange rate was to provide links between producers and foreign markets, creating both competition from imports and a stimulus for export-oriented production.

Along with the NEM came new instruments for promoting industrial strategy. To provide capital for the development of priority

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sectors, central capital allocations were consolidated into Central Development Programs (CDPs). CDPs reflect the recognition that

> in order to accomplish major changes in the production and utilization structure of the national economy, development programs requiring large investments are also needed whose selection and financing cannot be subject to decisions influenced by current market demand and market conditions—considerations related to enterprise profit interests. [Balassa 1975, p. 91]

The authorities could also make use of a system of credit policies and explicit and implicit subsidies to steer investments of enterprises toward priority sectors.

Six CDPs were to be started during the 1971–75 period. They included a scheme for expanding the use of natural gas; the development of the petrochemical, aluminum, and motor vehicle industries; the promotion of computer production and use; and the use of lightweight structures in construction. Balassa (1975) lists some of the objectives of these CDPs, from which we can gain some insight into the criteria employed by Hungarian planners in choosing priority sectors. The expansion of the production of natural gas and aluminum was based on the availability of natural resources, as well as on the expectation that some downstream technological improvements could be fostered by these two industries. Petrochemicals, computers, and buses were also expected to foster technological progress, not only with their respective industries but in supplying and consuming sectors as well. All projects, of course, anticipated rapid increases in production. On the foreign-trade front, the criteria were unequivocal: Road vehicles were to be directed to socialist countries "to earn foreign exchange"; aluminum, petrochemicals, and computers were destined for CMEA markets under cooperation agreements; and the computer program was to "accomplish the substitution of domestic products for imports from capitalist countries." Exports by any of these industries to capitalist countries were viewed as a minor consequence. The objectives of industrial policy in the early 1970s, then, were to promote sectors that would provide technological spillovers to the rest of the economy and would meet a large and dynamic demand on the CMEA market.

In view of Hungary's deteriorating terms of trade and acute need for convertible currency earnings in the 1970s, neither the vague, excessively inward-looking supply-side criteria nor the orientation to the demands of the CMEA market could serve as a continuing basis for Hungarian industrial policy. In October 1977 the Central Committee of the Hungarian Socialist Workers' Party met to discuss

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the need to reorient industrial policy. Calling attention to Hungary's worsened terms of trade, the increasing difficulty of exporting even to CMEA markets, and the slow pace of adaptation of Hungarian production to the new international environment, the committee's secretary called for the strengthening of industrial policies (Nemeth 1977). Products to be promoted should be of high quality, up to date, and profitable to produce, and should involve a high degree of processing. The ability of the economy to allocate resources to these priority sectors would be limited by "the relative scarcities of labour, of resources for accumulation and of foreign exchange"(p. 242). The low rate of growth of output, deteriorating terms of trade, and the need to maintain consumption levels and to increase investments in energy, made investment resources particularly tight. Nemeth identified energy production and utilization, the engineering industry, light industry, and agriculture as sectors that met the criteria for priority development. The engineering industry was seen as vital to the "long term development of the Hungarian economy, as well . . . as the intensification of socialist economic integration and of the . . . expansion of exports to the dollar area." Within engineering, the existing range of products was "too broad" and of "mediocre technical standards." Resources were to be focused on road vehicles, agricultural machinery, machine tools, precision engineering, telecommunications, and the vacuum technical industry. Nemeth recognized that this concentration of resources would require eliminating certain engineering products, but cautioned this should be done only on the basis of "permanent and secure imports" (p. 243). In light industry the strategy was to replace low-quality production with higher-quality, more sophisticated products, thus shifting the pattern of production to more profitable items.

The Central Committee issued a set of directives on industrial policy that established scale of production, standards of technology, management and organization, market and trade positions, and "production background" as criteria for selecting favored sectors. In addition greater attention was directed toward specialization, higher standards for products and management, domestic and foreign demand, and the availability of infrastructure and manpower. To further emphasize the reorientation of industrial policy toward Western markets, a fund of 45 billion forints was established to finance investments that would expand exports to the West.

Hungarian economists have engaged in a lively debate over the merits of the existing industrial policy and its results. Among the aspects most frequently criticized are the following.

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Criteria for Choosing Priority Sectors

Although economies of scale are used as a criterion for selecting priority sectors, such economies are often not obtained in practice (Roman 1978). In large part this occurs because it is assumed that economies of scale are to be reaped at the assembly stage. While some economies do exist at this stage, there are also large economies of scale in the production of components, subassemblies, and parts. This production in Hungary is not undertaken on a large scale by independent subcontractors, but rather by the enterprise responsible for assembly. Thus the production of these parts is usually carried out at a volume that either fails to capture economies of scale or actually suffers from diseconomies of scale. Benefits of mass production at the assembly stage, therefore, are offset by high-priced and inferior components. The stress on economies of scale may lead to the development of industries that rely on low-wage unskilled labor for their market advantage. In such industries Hungary is likely to lose comparative advantage to developing countries (Koves 1978, p. 112). Koves also criticizes the criterion of "modernity" or technological advance, arguing that "we may have to consider an important task to manufacture such products which otherwise do not fit at all into our ideas about a modern product pattern" but that are saleable on world markets due to "their good quality, flexible adjustment to individual demands, and fast delivery" (p. 112). While Koves' point is well taken, it is difficult to believe that quality, flexibility, and fast delivery were likely competitive strong points of the Hungarian economy in 1978, or that they would prove to be less elusive than economies of scale.

Finally, the criteria have been criticized because they lack a specific cost-benefit accounting (Roman 1978). There are no explicit considerations of the inputs needed to implement industrial policy. In particular the research and development expenditures, foreign licenses, and imports of components and parts required by priority projects do not appear to weigh heavily in determining development strategies. Evidently in this regard little progress has been made since the 1950s.

Criteria for Selecting Markets

As mentioned above, Hungarian industrial policy has been oriented toward import substitution and the needs of the CMEA market. As a consequence Hungary has developed a "dual economy." The CDPs rely on Western technology and equipment to develop large-scale production of goods saleable only on the CMEA market. The production technology is not advanced enough and the products are

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of insufficient quality to permit exports to the West. To the extent that the technology is not updated, these products eventually lose their appeal on the CMEA market as well (Koves 1978). At the same time, a more traditional and less well supported sector that does not rely on Western technology and equipment exports resource-intensive commodities to Western countries (Kadar 1978).

The orientation of industrial policy to the CMEA market is also believed to be responsible for the failure to stress efficiency, quality, high technical standards, and responsiveness in Hungarian export production (Roman 1978, p. 3). Moreover, the CMEA market absorbs large quantities of goods that are reaching the mature or declining stages of their product life cycle in Western markets. Thus, to capture economies of scale in production, Hungary must adopt products that are unlikely to face a dynamic demand in the West.

While there may be some truth to these arguments, in large part they appear to be self-serving. True, the CMEA market does not demand the latest goods with the highest quality. However, neither does it reject such products, and one certainly can find evidence that goods of high quality and embodying new technology fare well in CMEA trade. That the CMEA market does not demand such quality is not the cause of its absence from Hungary's exports. The true causes of the lack of quality must be sought elsewhere, particularly in Hungary's economic system.

The Economic System as a Barrier to Industrial Policy

Although under the NEM one-half of the investment funds are centrally controlled and the other half decentralized among the enterprises, investment decisions are viewed as being excessively centralized (Nemeth 1978; Soos 1978; Deak 1978). This is because enterprise funds are comingled with central funds or bank credits, or are subject to central policies and criteria when enterprises bargain for subsidies and favorable prices. As a consequence there are no funds available for entrepreneurs to invest on the part of enterprises; the center's investment policies encompass virtually all investment resources. Once these investments have been allocated, "there is not enough money left over for export-oriented development" (Roman 1978, p. 114).

The allocation of 45 billion forints for loans to increase the production of exports to the West does little to remedy this, since the amount is less than 10 percent of total investment. Moreover, the great demand for these funds means that firms offer to repay loans in three or four years, hardly enough time to make significant structural changes. Certainly if industrial policy is intended to go beyond the

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"narrow" concepts of enterprise profits and market fluctuations, then this fund would seem to do little to further industrial policies. Nevertheless, Kadar (1980, p. 283) argues that "it was not so much the central development programmes as the export-developing credit policy of the National Bank of Hungary that encouraged the expansion of Hungarian export capacities and their structural improvement."

The large size of Hungarian enterprises has resulted in a concentration of industry that reduces the decentralization inherent in the NEM. Often preferences for a particular sector or product become preferences for a single enterprise that has no competitors within Hungary (Deak 1978). Moreover, while branch ministries are to concern themselves with economic results rather than control over enterprise activities, when such results depend on the activities of one or a few enterprises, stimulating economic results and the direction of day-to-day activities become difficult to distinguish. To remedy these problems, Nyers and Tardos (1978, p. 41) suggest that enterprises be reorganized in a way reminiscent of Japanese *zaibatsu* (which include a bank and a trading company in addition to industrial plants) for purposes of investment allocation and enterprise guidance. Whether such a scheme would merely exacerbate the problems created by existing trusts (Keverai 1980) is unclear.

Finally, it is evident that the system lacks the incentives required to induce enterprises to produce quality goods that can compete on international markets. In this, of course, Hungary is not unique. While the new wave of reforms may deal with some of the systemic barriers to industrial policy, it is unlikely to solve them all.

In the case of Hungary it is evident that a number of systemic and environmental factors conspire to limit the types of industrial policy that can be successfully implemented. Most problematic are those industrial policies that rely on firm-specific sources of comparative advantage. The ability to preempt market share in industries where there is lumpiness of capital is low because neither the technological level of the Hungarian economy nor that of the Soviet Union, its largest customer, is geared toward goods that are new by world standards. The Ikarus bus example, therefore, is likely to be a fortuitous event, but an economy the size of Hungary's admittedly does not need too many such lucky finds. Hungarian firms are unlikely to rely more intensively on research and development. Nor are the domestic and CMEA markets likely to create greater pressures on Hungarian firms to push themselves to the point where they will enjoy significant competitive advantages over foreign firms on the basis of brand name or product differentiation. Thus, at the level of the firm, the only source of competitive advantage that industrial

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policy can create, given the lack of interest of the firms themselves in international competitiveness, is economies of scale. Unfortunately, in view of the high degree of concentration and the small size of the Hungarian economy, the only way in which such economies can be obtained is through international trade in components. Because of the difficulties of obtaining such components on CMEA markets, Hungary is faced with a serious dilemma in its industrial policy. While the reference market of industrial policy is CMEA, an economically viable industrial policy is possible only by expanding trade with the West, so that imports of components can be increased. If the favored sectors cannot earn the hard currency they need by exporting more to the West, then a greater hard-currency export burden will be placed on the rest of the economy. There is a danger that these less-favored sectors—that are not given preferred access to capital and labor but that generate a disproportional share of hard-currency exports—will seek to gain power so as to improve their access to domestic resources, thus subverting the preferences of the planners.

The economy-wide sources of industrial policy, the structure-determining and productivity-growth elements, can also be fostered by the authorities, but they merely create the potential for export-oriented sectors to develop. As the experience under the period of central planning shows, the ultimate success or failure of industrial policy is at the enterprise level.

The Development of Hungarian Agriculture as an Example of Industrial Policy

The strikingly good performance of Hungarian agriculture in the 1970s and 1980s in terms of yields, domestic consumption of foodstuffs, and exports is viewed by many observers, Hungarian and foreign, as an example of what enlightened support of a sector, coupled with policies that promote individual initiative, can achieve. The case of agriculture and food processing is also appealing to many because agriculture appears to be a sector marked for promotion on the basis of the Heckscher-Ohlin doctrine. As one Hungarian economist put it, "[g]ood crop land is the most important natural resource of Hungary" (Csaki 1983, p. 317).

The alleged promotion of agriculture, through both favorable allocations of resources and systemic reforms, was based on a number of objectives. First, in the 1950s, agricultural performance was unsatisfactory in that Hungary was a net importer of grains. This not only strained the hard-currency balance of payments but also precluded an expansion of the livestock sector, since such an expansion would

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have required additional supplies of fodder. Thus import substitution, either of fodder or meat, was one reason for promoting agriculture. Another reason for increasing the supply of capital and industrial inputs to agriculture was to improve the structure of the economy by moving labor out of agriculture and into industry, where labor productivity and its growth were higher.[5]

The first steps toward improving agricultural performance were to give agricultural units greater autonomy. Thus in 1957 compulsory deliveries were eliminated and procurement prices were raised. In the 1960s investment in agriculture was increased, with the construction of buildings as a first priority, followed later by greater attention to agricultural machinery. By this time agriculture's export potential was becoming evident and there were expectations that the burgeoning agricultural surplus could be exported to hard-currency markets.

As a result of the NEM reforms, agricultural units obtained the legal and financial means of exercising the autonomy that previously had been granted to them (Swain 1981). In addition to this enlightened policy of autonomy for collective farms and benevolent neglect of private-plot agriculture, Hungarian agriculture benefited from a large infusion of foreign technology. This was largely the result of the initiative of one individual, Robert Burget, who took advantage of the autonomy granted to agricultural units to develop the Babolna State Farm into a modern producer of poultry and pigs. Joining forces with a West German poultry-breeding firm, he introduced modern methods of animal husbandry and succeeded in exporting a good part of his output to Western markets. The next step was to import American corn-growing technology, to provide a reliable source of feed for the animal husbandry operation. This new method of scientific agriculture, often called TOPS (technically operated production systems), was then disseminated by Babolna, and by several Schumpeterian imitators, to other Hungarian farms on a cooperative basis.[6]

Despite the favorable anecdotal evidence regarding its performance, Hungarian agriculture appears to share a disturbing similarity with the rest of the Hungarian economy: The aggregate numbers somehow fail to reflect the favorable impression gained from the anecdotal evidence. Examining the data, rather than the statements

[5]Even at the end of the 1950s, agriculture employed about 40 percent of the labor force but accounted for only a little over 20 percent of gross production.

[6]For brief descriptions of the Babolna experience, see Marrese (1983) or Swain (1981). A detailed description is available in Winpenny (1981).

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of Hungarian and Western observers, leads one to wonder whether agriculture has really been favored by government policy. Agriculture's share in aggregate investment, with the exception of 1968–71, has held relatively steady for the past 15 years. At the same time agriculture's share of the labor force has been cut in half. These trends in inputs have been reflected in agriculture's share of net production, which fell from 21.9 percent in 1965 to 14.8 percent in 1976 (Swain 1981). Finally, agriculture's share of exports has held remarkably steady—between 21 and 24 percent since the early 1960s.

Of course, the pricing of agricultural output has much to do with our perception of agriculture's performance. It is often argued that agricultural prices are too low, largely as part of consumption policy but also to avoid too great a differentiation in farm incomes. Thus while the prices of industrial products, including inputs to agriculture, have risen, agricultural prices, save those tied to world market prices, have remained relatively stable to shield consumers from inflation. Although this is a valid point, it must also be borne in mind that many inputs to agriculture are subsidized as well (Swain 1981; Csaki 1983, pp. 327–28). Finally, the ability of Hungarian agriculture to turn its surplus production into hard-currency earnings has been hampered by West European restrictions on imports of agricultural products.

Overall, the agricultural system in Hungary has benefited from relatively enlightened government policies regarding the organization of agricultural production and its ability to make effective use of foreign technology and market opportunities. While such policies are obviously a form of support for the agricultural sector, particularly in comparison to developments in other socialist countries, it is also difficult to conclude that agriculture has benefited from policies to improve its access to labor and capital. While individual elements of price, infrastructure, and credit subsidies exist, they may be more than offset by price distortions that work to the disadvantage of agriculture.

Lessons from the Hungarian Experience

Surprisingly our survey of Hungarian experience with industrial policy suggests that choosing sectors to promote has not been especially difficult. Hungarian planners have been able to identify products that were in demand on the CMEA market and that could be produced under conditions that should have benefited from some firm-specific element of competitive advantage. Similarly there appears to have been little indecision about Hungary's target market.

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The fact that Hungarian planners were able to identify a target market for their industrial policy should be viewed as a mixed success at best. That the socialist countries and the Soviet Union in particular did provide a large and relatively stable market for Hungarian products does not mean that it was the best reference market for formulating Hungarian industrial policy. Possibly an industrial policy oriented toward the West might have developed industries in the long run that could have exported successfully to both CMEA and the West.

That the choice of sector and market has been relatively easy for Hungarian planners should not be construed as proof that such choices would be equally easy for policymakers in the United States. The sectors Hungary chose to support are relatively traditional. If the policy of the United States were to be directed toward technologically advanced sectors, then choices would become more difficult, though perhaps not too much more so. The choice of markets for the United States is a more serious obstacle to the formulation of a viable industrial policy. Given the size and technological level of the United States economy, the obvious reference market for the United States is its own domestic market. However, by directing industrial policy toward the domestic market, there is a danger that industrial policy will turn into a policy of protectionism rather than a policy whose outcomes would have to meet the test of the world market.

The allocation of resources to favored sectors in Hungary, as in other countries, has been a source of controversy. In Hungary the problem has been that favored sectors pay a price for government support, in that they are forced to conform to government objectives that go beyond those of the industrial policy and may be inconsistent with the long-run economic performance of the firm. A second problem has been that in Hungary, and to an even greater extent in Poland, the benefits to firms of participating in industrial policy programs, regardless of their likelihood of success, have been so great that virtually all firms have lobbied to be part of industrial policy (Brada and Montias 1984). Finally, industrial policy has tended to be inflationary. To the extent that certain sectors are given priority access to capital and labor, other sectors must be made to reduce their demands for capital and to release workers to the priority sector. In general, planners in East Europe have been reluctant to shift resources away from entrenched industrial interests, so investments in favored sectors are generally seen as expenditures over and above the normal volume of investment, rather than as a redirection of a given volume of investment. Such problems, of course, could easily crop up in the

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course of implementing an industrial policy in the United States as well.

The evident difficulty with Hungary's industrial policy has been one of implementation. However well planners may have identified products for promotion and markets where such products could be sold, even when resources were directed toward these sectors it has more often than not proven impossible to create the firm-specific sources of competitive advantage that are required for the ultimate success of industrial policy. Partly this has been a systemic problem. Hungarian enterprises lack both the incentives to exploit the opportunities perceived by the framers of industrial policy and the penalties for failing to act. The autarkic approach to industrial policy has also created serious difficulties in implementing it. Only in the production of buses have the Hungarians succeeded in implementing the objectives of their industrial policy. This case stands out largely because it is the only example of industrial policy where the internationalization of the priority sector was evident from the beginning and also particularly extensive in its contacts with foreign suppliers. Agriculture, while perhaps not as strongly supported as the bus program, has also benefited from extensive reliance on foreign inputs and technologies, as well as from stronger incentives and greater freedom of decision making. These two Hungarian successes indicate that the internationalization of production is an important component of success in implementing industrial policy. An examination of the debate over industrial policy in the United States reveals that this lesson needs to be considered by both proponents and opponents of industrial policy.

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"INDUSTRIAL POLICY IN HUNGARY": A COMMENT

Paul Craig Roberts

Professor Brada (1984) concludes from his survey of Hungarian economic experience that one of the more difficult aspects of formulating industrial policy has been the selection of the sectors to be promoted. I do not think that should surprise us. The people who are the most expert at selecting the sectors to be promoted are the capitalists. They have a hard time playing their own game. It seems only obvious that government bureaucrats trying to imitate them are going to do worse. The question, then, is: Why have bureaucrats instead of capitalists?

Ever since Oscar Langer redefined central economic planning to be market simulation, there has been no reason for any planning (Roberts 1971). It is obvious that no bureaucrats will ever be able to simulate the activities of the real experts—the capitalists themselves. And of course we know that bureaucrats will never face the same incentives as venture capitalists. By now everyone knows that a fundamental problem with so-called socialist or planned economies is the absence of private capital markets. What, then, could be the reason in the United States for having an industrial policy other than to overrule the decisions of the capital markets? The only obvious reason to have an industrial policy is to increase the power of government.

The United States once had an industrial policy. It was run by the Reconstruction Finance Corporation (RFC). If the Hungarians are smart, they will learn their lessons from us. The United States dissolved its industrial policy in 1953, amid charges of corruption, fraud, and political favoritism. An article in the January 1952 issue of *Harper's* magazine confirmed the Senate Banking Committee's 1951

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investigation of the RFC. It reported that the RFC had "thrust money on the proprietors of road-side snake farms, cultivators of cactus plants for sale in dime stores, dental clinics, paperboard makers, mattress makers, television manufacturers, canneries, movie houses, cafes, drug stores, truckers, a trailer manufacturer, a manufacturer of fluorescent lamps, a rainbow trout factory, and some very dubious fellows who wanted to be the concessionaires for the roulette room in a Nevada hotel." Someone remarked that the last item was probably the most successful of the RFC's capital allocations.

When I read between the lines of Professor Brada's paper, I believe I could conclude that in Hungary there is the use of "industrial policy" to dismantle or rationalize the remnants of central planning in Hungary. In the United States, however, industrial policy is an effort to replace liberty with government power. In the 1930s, 1940s, 1950s, and 1960s, academics could pretend that there was more to be gained than lost from subordinating liberty and elevating government power. They had careless theories about "market failure" despite the fact that every day they relied on markets to meet their needs. They produced slogans about how, once government had enough power, "planned production for community consumption" would replace the chaotic market economy. When F. A. Hayek and others argued that central planning would destroy liberty, many academics denied the obvious. One even went so far as to deny that Joseph Stalin was a dictator on the grounds that the Soviet constitution provided for no such office.

Today academics can no longer carry on the pretenses about the failures of markets and the successes of central planning. When it became impossible any longer to defend the Soviet economy, those academics who require a socialist illusion shifted to communist China. At Stanford University in the early 1970s, John Gurley, once the distinguished editor of the *American Economic Review*, found nirvana in Maoist economics. Today China itself is ruled by a convicted "capitalist roader," Deng Xiaoping, who is talking about opening a stock market. That and the generalized failure of central economic planning leave socialist-minded academics with only a sparse symbolism. The once fabulous claims for central economic planning have been reduced to a drab industrial policy, and in Hungary, Brada tells us, its only success is the production of buses. What socialist can be enthusiastic over that?

We have wasted several decades of scholarship while academics bent over backward to find successes in "Soviet-type economies." Today the last remaining claim for planning is the bus industry in

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Hungary. With this pathetic claim, a sordid episode in the history of scholarship has come to an end.

Democratic societies must find some way to hold universities accountable. The politicization of scholarship that allowed academics to keep the failures of socialism under wraps for several decades, while they prattled on about the failures of markets, has adversely affected the lives and fortunes of large numbers of people. The social costs at home and abroad of this academic failure are enormous. I cannot say that the benefits of academic economics compensate for these costs.

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ECONOMIC REFORM IN HUNGARY: ROLE OF PLAN AND MARKET

Janos Horvath

The question posed by Brada's paper (1984) is an important one: "Are there lessons for America from industrial policy in Hungary?" Quite likely the affirmative answer will ring with varying amplitudes of consent; all the way from a whispered "perhaps" to a resounding "yes." The differing degrees of consent may depend on the elements, processes, achievements, and institutions compared. Yet, in order to answer the question posed above, the inquiry must not be confined to international statistics which deal with size, growth, stability, equity, and other conventional indicators. The question can be more meaningfully answered by tracing changes in systemic parameters and variables such as plan, market, incentives, subsidies, mobility, and propensity to experiment. Indeed, by placing the United States and Hungary into juxtaposition as they currently debate their own industrial policy, some thought-provoking insights can be gained.

My answer to the rhetorical question posed by Brada's paper is that in the 1980s there are certain noteworthy lessons for America from Hungary as industrial policy issues evolve in the two countries. The prime lesson I find is that nowadays the Hungarians seem to trust the market mechanism more and the planning process less than the Americans. While the market's role is rising and the plan's role is declining in Hungary, simultaneously in the United States a reverse trend is afoot—a trend to reassign significant functions from the market sector to a planning apparatus. This trend is evident in the call for an industrial policy, the controversy over the deregulation of selected industries, and the rise in protectionist sentiment. In each

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of these cases special interest groups are striving to retain some special subsidy or bounty. The tyranny of the status quo is a reality.

I hasten to caution anybody against overrating Hungary as a role model in comparison with the United States. A sense of proportion is indispensable. Notwithstanding controversies around governmental involvement with the economy—essentially through monetary and fiscal policies and business regulations—the representative form of government and market feedback mechanism do share decision-making in the United States. Competing ideas and institutions, bolstered by pressures of innovation, necessitate acceptable performance because of the threat of losing office and/or customers. In Hungary, the Communist Party continues to retain monopoly over the government as well as all essential public decision making throughout all segments of the society. No alternative ideologies and institutional arrangements are permitted to compete for the people's choice. There is no voting mechanism, for example, to reject the status quo; there is no chance for rotating governing elites via the democratic process.

The Intolerable Failures of Centralization

Now having pegged out the place of Hungary vis-à-vis the United States on the multi-dimensional map of contemporary realities, we may proceed to deal with the task stated at the outset. Professor Brada's paper sketches the framework for industrial policy in Hungary, identifies its salient events, and analyzes the evolving process accurately. What appears pertinent to add is that post–World War II Hungary, then still working within a market-coordinated, private-enterprise economic system, had accomplished during two years a remarkable reconstruction of industry and stabilization of money. Hungary's current industrialization policy reaches back to the political regimentation of Eastern Europe, which, in turn, imposed a centrally directed economic mechanism. As the country's political economy became patterned on that of the Soviet Union, plans were decreed and their implementation enforced "from the top down." After lengthy toils and traumas, most visibly the revolutionary reform attempts in 1956, the New Economic Mechanism was introduced in 1968 under which the state began to share decision-making roles with enterprise managers and broader segments of the populace.

During the 1970s the reform had certain setbacks and reinforcements until another resolute commitment in 1984. The tone and sophistication of the new reform movement can be seen from the following selection of excerpts from various studies, proposals, and

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policy statements that have been produced in Hungary during the recent phase of national introspection.

In his 1984 New Year interview, "Newer Wave of Reforms," Ivan T. Berend, a leading historian, academican, and former rector of the Karl Marx University of Economics, reflects the state of a national soul-search (Berend 1983):

> We have learnt at a very high historical price what *must not* be done in guiding the economy. Consequently the reform began. . . . The reform does involve risks, but the greatest risk is if we fail to accept the risk. Otherwise we cannot overcome the current difficulties which resulted from changes in the world economy as well as from our own weaknesses. We cannot afford to wait any longer. Due to the deteriorating terms of trade, the national income of a whole year has been lost in the course of the past 10 years. . . .

Willing to touch old taboos, such as the ideological commitment to full employment, Berend continues:

> Presently in Hungary full employment is based on two pillars. One is the large factories where there is "over-employment" with harmful consequences. The other pillar is the retirement system. Women are eligible to retire at 55 years of age and men at 60. Full employment would not be possible otherwise, therefore 20 percent of the population is on pension. This retirement system could be regarded as a way of unemployment assistance. . . . The reallocation of labor force and material resources must be facilitated. Those enterprises, with only small exception, which are chronically incapable of breaking even, where the loss becomes permanent, *must not be subsidized.* The retrained workers find jobs at prosperous enterprises. The economy gains new momentum while the best enterprises and the best sectors of production advance to the forefront. Precious years have already been lost; we cannot afford to lose more.

Berend argues the case for market solutions, even in the ideologically very sensitive area of income distribution, by showing positive results:

> The weakest segment is the state-owned manufacturing sector which also amounts to the largest sector of the national economy. It is here where the implementation of reform continues to lag behind expectations. The present difficult situation compels a consistent implementation of reform accepting the consequences of free price, wage, and investment adjustments. . . . The effective income stimulators led to higher income for some people—supposedly an undesirable phenomenon from the viewpoint of social stability. However, higher income stimulated more private saving, which in turn resulted in private investment in the service sector. Examples abound; here is a recent one. The introduction of a private taxicab system by a stroke of the pen, resulted in the doubling of the fleet in Budapest without

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> any state investment. Another success story is agriculture where the reforms have had the longest time to work their way. Indeed, in agriculture the 1968-type reforms had already begun in 1956.

The disappointment with concentrated economic power sounds like a textbook case against the evils of monopolies. Such encouraging sentiment inside Hungary's Ministry of Industry is expressed by senior policy analyst Gyorgy Marosan, who writes:

> During the past decades it was a general doctrine of economic policy that the central direction could optimally allocate resources for development. . . . Unfortunately, experiences proved differently; quite often the expected success failed to materialize. No efficient sorting out of viable investment projects was possible within the given system of governmental directives which led central decision-making toward irrational directions. Arbitrarily chosen priorities resulted in weakening norms, unjustified preferences, and ultimately declining performance. Consequently, the preferred enterprises syphoned away resources from other areas. What aggravated the problems was that the enterprises in monopoly positions became preoccupied with protecting their privileges instead of strengthening competitive edges. [Marosan 1983, pp. 15–16]

From Centralized Directives toward Market Solutions

That the above statements are typical of present-day Hungary could be documented at length. Evidence abounds. What is noteworthy is that the lengthy and meticulous diagnosis has been leading to prescriptions to remedy pains and retardations. Decisive actions are called for with compelling urgency. For example, while gauging Hungary's position within the world economy, Bela Kadar reports (1983, p. 45): "The unfavorable changes in the external and internal conditions of Hungary's socio-economic development have recently made it particularly imperative to increase the efficiency of Hungarian industry." In fact specific steps toward reforms are recommended at various forums. Due to the fact that Kadar based his recommendations on the broader context of resource endowment, technological capabilities, and performance indicators, as well as institutional structure, it appears that his operational design has viability. The salient points are:

> In the years to come the dynamism and stability of the economy will thus primarily depend on how the efficiency and international competitiveness of Hungarian industry can be improved, and how the various conditions of participating more successfully in the international division of labor can be created. In the 1980s, therefore, the tracing of its path of growth will not simply be an expedient

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but also a social necessity determined by the unfavorable change in the internal and external conditions.

. . . The conditions and requirements of international industrial development in the 1980s . . . have brought still more into prominence the importance of independence in enterprise decision-making for industrial policy. A system of enterprises, each of which has a direct interest in its own performance and operates independently with varied forms of ownership and different sizes of organization, can define products, means of execution, a management mechanism and organizational structure of its own.

The functioning of a market-oriented system of economic management and economic environment would bring out the comparative advantages and disadvantages of particular industrial products. . . . This can be done within the framework of engaging more intensively in international cooperation between enterprises.

In macro-economic management of industry . . . those direct methods of management—almost directives—must be replaced by those whose management strategy is of an indirect, coordinating character. . . .

A path of growth that demands innovation and technical improvement, a strengthening of competitiveness and developing of infrastructure, usually requires very intensive investment. An internal economic prerequisite for this is to enhance the economy's ability to save, to encourage individual and enterprise savings, to decide on appropriate real rates of interest and real capital expenses. . . . The development of certain sectors requires direct, close cooperation with long-term foreign capital, the evolution of joint ownership. . . .

[One] can draw an appropriate profile of specialization without central interference where good opportunities for finance are available through self-generated resources, or from banks, and this should apply to 60 to 70 percent of the products of the processing industry.

[Kadar 1983, pp. 55, 60–61]

The prospects of technical development continue to be the topic of several symposia which focus on creating a favorable environment for future progress. Engineers urge that the first economic-financial task should be to rectify the grossly arbitrary price and wage system which fundamentally distorts the evaluating feedback mechanism and consequently hinders technical progress. Distorted price ratios among material, energy, and final products not only curb long-range growth but also stimulate waste. All observers advise against the coordination of development projects by state officials (Vamos 1983, pp. 85, 89).

Broad ranges of infrastructure studies are integrated by Ehrlich (1983, pp. 33–36) in search of management formulas which could lower the capital/output and labor/output ratios. The innovators

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advocate "several sectors" conducive to competition between them. The "several sector" design means that within a specific infrastructure branch "the state, cooperative, family, and private sectors [ownerships] are operating side by side, their proportions being determined by technical parameters" (Ehrlich 1983, p. 34). Naturally the exclusivity of state ownership must be retained in several areas, yet "it will be expedient to spread and/or make characteristic the small cooperative, family, and private undertakings which are going to evoke true ownership identification in several fields" (Ehrlich, p. 34). The spreading of the "several sector" framework would bring about (1) the abolition of subsidies; (2) the enhancement of capital formation as private ventures recycle a part of their relatively higher personal incomes; (3) the legalization of some of the presently half-legal or illegal activities as part of the "second economy"; (4) freeing the state from the burden of investment appropriations in certain areas; and (5) the design of a workable system of income taxation as successful microeconomic enterprises give rise to entrepreneurial profit.

In reference to a rather controversial 1983 event, Rezso Nyers reflects:

> It was fully understandable for me that a young cadre demanded more forceful reform policy. . . . What also contributed to the increased tension was that after 1979, motivated by the continuation of reform policy, certain fully rational measures were taken to stimulate small enterprises. Now balancing the advantages and drawbacks, I believe that the gains dominate even for those who feel drawbacks momentarily. But this intense change, while opening doors for a characteristically free market sphere—within our imperfectly functioning and in essence only simulated markets—did cause conflict in the income distribution. The resolution of such a market dilemma could come only through the reinforcement of economic reforms. Where do the directions of progress lie? First, more enterprising business management is needed. Second, the price, wage, tax, credit, and financial systems [need to] consistently broaden the freedom of enterprise management. [Nyers 1984, p. 14]

On the Limits of Experimentation

No need to belabor the fact that Hungary's economic reforms are not conducted in a political power vacuum. The country's geography, history, and international commitments do stake out room for experimentation. Yet the boundaries of experimentation are not always staked out unequivocally.

The above excerpts reflect the motives, the directions, and some of the accomplishments of the reformers. And it must be made clear

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that the reform measures have been approved by the political establishment, which also encourages the careful contemplation of further scenarios. But occasionally the ground rules are reiterated. The politicians, who assert a sort of midwife role, do from time to time remind the reformers that there are limits to the experimentation. The message might be phrased this way:

> A few years ago the political sphere initiated a process that could be labeled "reform movement." And we continue to endorse its continuation. However, as a political reality, only we can be the guardian of further experimentation. Therefore criticism rooted in distrust, and demands which mobilize adversaries, will only make our task more difficult. Instead of continuous criticism we expect expert advice. A little tension does no harm, but it hardly does any good if the advocates get carried away and overestimate their own importance. [Kovacs 1984, p. 47]

The above is perhaps the most formalistic assertion of the political sphere. In the balancing act of dogmatism versus pragmatism, a communist philosopher reflects upon re-reading Marx: "To sum up current Marxist thinking in Hungary: [F]or our present time the most important lesson from the Marxist legacy is the openness toward new realities and the ability for self-criticism. Nothing separates more distinctly Marx and Engels from certain latter-day Marxists than the capability to correct ideological dogmas in the light of new facts" (Agh 1984, p. 12).

While reassuring itself of authentic Marxist ideology and guarding the commanding heights, the political establishment remains cognizant of two meaningful challenges. One is an entrenched orthodox oligarchy inside the country and the other is the Soviet-led fraternity of communist countries. Whatever other challenges might exist, they do not pose the same threat for destabilization.

Domestically the powerful group which nurtures reservations against economic reformism, even though subdued, consists of the managers of several hundred large factories. With few exceptions their failures are well known and their frustrations are recognizable. They feel intellectually orthodox and professionally obsolete, and their inferior performance remains a public issue. Comparisons are embarrassing. That manufacturing lags far behind its potential while agriculture reaches new heights is well recognized. It is also recognized that these two sectors are managed quite differently. In agriculture managerial decisions are delegated to hundreds of thousands of producing units, and the market mechanism is the primary coordinator. In manufacturing the managers tend to avoid making creative decisions; they feel more comfortable executing directions from higher

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authority than in shaping decisions based on feedback from the fresh breeze of market competition. The contrast in favor of agriculture is manifest in higher personal income and adaptability in export markets.

The limping manufacturing sector would improve through more reliance on the market mechanism, but the orthodox managers want no more operational discretion. They sparsely use the freedom bestowed on them. Oligarchies prefer to perpetuate the status quo. Of course some medieval monarchs managed to shake up their reluctant barons. For Hungary's present political leaders it could become a crucial matter how to retire thousands of oligarchs whose positions were granted in an earlier period as a reward for loyalty. Attrition may lead toward the solution although it may be slower than affordable. Nevertheless, to ascertain the viability of the ongoing market system in Hungary, and to remove its detractors, might prove more urgent than any immediate tinkering with the mechanism (Horvath 1984).

The international approval of Hungarian economic reforms continues to be a crucial consideration. An authoritative insight was recently offered by Rezso Nyers, a former secretary of the Central Committee of the Communist Party, the highest-ranking official responsible for adopting the reform breakthrough in 1968. Removed from the highest power elite since the early 1970s, he participates again in economic policymaking. Perhaps it is symbolic that he gave an interview to *Mozgo Vilag (Moving World)*, a journal best known for innovative inquiries and, occasionally, for initiating controversies. Nyers, as quoted below, masterfully blends competence, courage, and caution:

> Indeed, it would be a significant gain for the Hungarian economy if equivalent reforms were afoot in the CMEA countries [the Soviet bloc economic alliance]. The need for them is real. The possibilities? Well, to some degree they also exist; it is not impossible that the reforms could begin; we see experiments within the economic mechanism even in the Soviet Union. There are signs in Bulgaria. In Poland, they have adopted an economic reform in the political sense for which, however, the economic preconditions are still lacking. Yet, I think that the Hungarian reform policy now enjoys a broader basis . . . or, worded more precisely, encounters definitely less resistance from other countries than after 1968. So the conditions are becoming better, but we cannot anticipate from them similar reforms during the immediate years regarding the interaction of plan and market. . . . This could be viewed as a brake, because the CMEA alliance offers reduced development stimulation to the Hungarian economy as well as to other member countries.
>
> Even the most sensitive matters should not remain taboos. I do believe that first we should wisely broaden the circle of questions which are not sensitive. Then more truthfully, more sensitively, and

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> very carefully truth must be spoken. Naturally it is a very, very sensitive political question to decide how far to extend independence in the domain of the economic mechanism and economic policy side by side with an alliance. It is my most firm opinion, that side by side with a good alliance relationship, there is still room to advance our independence. In this pursuit the debates must be accepted, even momentary disagreements, hoping that in the longer run even this kind of debate will strengthen the alliance. . . . At the time of each world tension, there will emerge a sense of meditation in communist political thinking . . . even the perception of isolation from the world economy. But I cannot imagine turning our back on the world market. Nor can I imagine the Soviet Union or the whole socialist world doing so. . . . We are open [to reform] in all directions, and the future prospects for its continuation are good.
>
> [Nyers 1984, pp. 16–17]

"From Others' Misfortune Learn the Wise"[1]

The evidence filtering through these pages substantiates the proposition offered at the outset. It is well worth our while in the United States to look at Hungary. That small country in Central Europe existing under adverse circumstances—resource paucity, historical misfortunes, institutional rigidities—has recently been achieving noteworthy results by substituting market for plan. Present-day Hungary wrings a savory livelihood from a bastard political economy by humanizing it through the cleansing breeze of market interactions. Favorable performance vindicates reforms, which deliver improvement, which reinforces calls for reforms, and so on. The circle seems to be self-sustaining through an intellectual-politicial-populist interaction. After rigorous studies the Hungarian economists recognized the market's curative potential. They have succeeded in converting the political leaders, who in turn proclaimed the laws of supply and demand a law of the country. Also, economic reform has broad popular support.

It is a recurrent observation nowadays in comparative analysis that Hungary has evolved as the most interesting experimental laboratory in terms of managing a nation's economy. The road from Stalinist central-plan enforcement to market socialism has been longer than any country traveled in the domain of economic systems. Hungary's dynamic evolution is particularly remarkable given its constraints on resource ownership, the concentration of management, and governmental involvement. Countries tend to be quite static by these measures; for example, the United States, the Soviet Union, Sweden, and

[1]A Hungarian proverb.

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other countries remain where they had been throughout several decades. Exceptions occur when revolutionary political turnabouts cause radical changes in the economic sphere. Measurable change in the economic system remains so rare that the currently ongoing Hungarian experiment has no forerunner or prototype, especially not inside the Soviet bloc with its firmly enforced ground rules for emulating the Soviet model of central planning.

Hungary's differentiation from the Soviet bloc economic blueprint draws its driving momentum from theoretical explorations and empirical testings. Hungarian economists and policymakers are fully knowledgeable about the strengths and weaknesses of the market system as well as about the theorems of "market failure." At the same time they are in the position to assess the strengths and weaknesses of the centrally planned system as well as the theorem of "plan failure." Further studies could shed more light on this topic, but the lesson for America from the Hungarian economic reform is clear: The Hungarian experience serves as a reminder that the inherent planning failures far outweigh the inherent market failures.[2]

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[2]Perhaps the time is now right for market advocates to fund economic study tours to send planning advocates to Hungary.

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JAPANESE ECONOMIC SUCCESS: INDUSTRIAL POLICY OR FREE MARKET?

Katsuro Sakoh

Introduction

The advocacy of an "industrial policy" or a more extensive "government-business partnership" has come into vogue in recent years in the United States, particularly among political leaders. Indeed the idea that the United States must move in that direction appears to have become almost conventional wisdom in Washington.

Although it is not clear precisely what an "industrial policy" might entail, or how a "business-government partnership" would benefit this country's economic growth, it is quite apparent why these ideas are so widely promoted and so favorably received. American political and business leaders believe that the prime reason for Japan's phenomenal economic growth rate and industrial success since World War II has been the Japanese government's extensive involvement in economic activities. To those who are concerned with American competitiveness in the international market, it seems logical for the U.S. government to assume a similar, major role in directing this nation's economy; in other words, to formulate an American "industrial policy."

The basic question is: Is it possible for *any* nation to generate and ensure its economic vitality by having its government play a major role in directing economic activities?

Most businessmen and economists would answer this question by stating that, in general, heavy government involvement in a nation's economic activities is detrimental to economic vitality. Yet many others, particularly politicians and political scientists, either disagree or tend to consider Japan a fascinating exception. Chalmers Johnson

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of the University of California at Berkeley—himself a political scientist—argues in his best-selling book, *MITI and the Japanese Miracle* (1982), that the Ministry of International Trade and Industry (MITI) has been instrumental in promoting Japan's economic growth.

Before Americans accept the policy of greater government intervention, based on hasty conclusions about the role Japan's industrial policies have played in achieving economic success, there are some legitimate questions that should be addressed. This brief paper is an attempt to provide at least some answers to the following questions:

1. How and to what extent has the Japanese government been involved in the economy through government expenditures, capital formation, financial sources, the ownership of corporations, and research and development (R&D) funds?
2. Is there clear evidence that certain manufacturing industries were significantly targeted by the Japanese government (through measures such as import protection, special privileges, financial aid, special tax policies)? If so, have these heavily "targeted" industries been successful in terms of economic efficiency and international competitiveness?
3. Have the bulk of the thousands of private entrepreneurs in Japan with their diverse interests in a highly competitive environment invested their capital, hired their employees, selected new technology, or developed their marketing strategies after consulting government officials?
4. Is there any evidence that an invigorated postwar market economy in Japan deserves major credit for that nation's economic success and for the maintenance of Japan's economic competitiveness through the two oil crises of the 1970s?

The Government's Role in the Japanese Economy

In order to correctly perceive the relative importance of the government's economic role, it is important to analyze the macro aspects of the Japanese economy.

One of the conspicuously positive contributions of the government, especially during the 1950s and 1960s, was its tax and expenditure policies. Government officials were determined to keep a tight lid on the growth of expenditures and to maintain small deficits until the early 1970s.

By keeping its spending for social welfare, quality-of-life, and national defense programs minimal, Japan was able to restrain the rate of spending growth relative to the rate of overall economic

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growth. Because tax revenues increased with economic growth, the government could afford not only to maintain balanced budgets (even surpluses in some years) but to reduce taxes every year.

As a result the tax burden on Japanese citizens was kept low and is still the lowest among developed nations. In 1980, tax revenue was 26 percent of GNP in Japan, 31 percent in the United States, 36 percent in England, 37 percent in West Germany, and 42 percent in France (OECD 1983, p. 60). There is little doubt that this tax policy has enhanced entrepreneurial incentives and encouraged savings and corporate investment in Japan. Moreover, Japan's policy of small and balanced budgets has provided a favorable business climate, and allowed the private sector to make first claim on investable capital resources.

The fact that the government was spending less than it took in tended to have a deflationary effect on Japan's economy, thereby helping to curb the inflationary tendency of the 1950s and 1960s. This, in turn, encouraged greater capital investment. The low tax burden and the government's spending restraint (before the 1970s) also explain why the Japanese government's economic involvement was minimal and much smaller than most industrial nations.

The limited nature of government involvement in Japan is further demonstrated by the figures on capital formation and lending sources. The private sector clearly accounts for the dominant share of total capital formation in Japan. During the period of most rapid expansion, 1961 to 1970, the share of private investment in machinery and equipment amounted to nearly 75 percent of the total capital formation. With regard to lending, nearly 90 percent of outstanding loans in Japan have been handled by private financial institutions, largely by city and regional banks, and only 10 percent have been provided by government financial institutions.

Some other straightforward ways of gauging government involvement in the Japanese economy are to determine the level of government funding on R&D, and the number and importance of state-owned-and-run enterprises.

The government's role in funding R&D has been very limited in Japan, especially when compared to that of industrialized nations of the West today. By the late 1970s the government share of gross R&D expenditures (including defense) was 58 percent for France, 48 percent for England, 48 percent for the United States, 44 percent for West Germany, and 28 percent for Japan (*Journal of Japanese Trade and Industry* 1983).

Likewise, state ownership of enterprises is very limited in Japan, especially in comparison to European countries. For example the

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Japanese government does not own any manufacturing industries with the exception of cigarettes. However almost all European governments own and operate major manufacturing industries such as iron and steel, automobile, aircraft, and, in France, even high-tech products.

Moreover an important aspect of Japanese government ownership is that state corporations do not have business monopolies. The Japanese government permits private-sector competition with its own enterprises. For example private railway companies and private bus lines are competing for the nation's transportation services with the governmentally owned Japanese National Railways (JNR) and municipally owned bus systems.

In addition to the fact that government involvement in overall economic activities was limited, especially prior to the 1970s, there are at least two other factors that explain how the Japanese government contributed to that country's economic growth. One factor is the government monetary policy. Shortly after the war, Japanese officials, realizing that private banks would be a primary source of ample credit for industrial operations and expansion, decided to maintain an artificially low and stable rate of interest. Furthermore they adopted a lenient position on the "overloan" practice by city and regional banks, which provided most of the nation's financial needs. This monetary policy was not greatly changed, especially before the early 1970s, except when the nation's balance of payments appeared at certain times to approach a deficit. Regardless of the pros and cons of this policy, the point is that Japanese monetary authorities were obviously very supportive of Japanese entrepreneurs and the business sector's need for capital investment.

A similar attitude can be seen in the priority of government spending. Although small in absolute terms, government spending, especially during the 1950s and 1960s, emphasized the nation's infrastructure in the form of roads, flood-control projects, harbors, airports, and basic industries such as hydroelectric power. These investments were seen as more useful than, and so took precedence over, spending on social welfare programs or environmental programs.

During the 1970s this general policy of creating a favorable environment for the Japanese private sector was profoundly changed by the government policies. The government not only abandoned its previous policy of balanced budgets but began to issue bonds to cover the deficits in its revenues. The volume of the bond issues increased substantially every year after 1972, partly because of more government spending on social welfare and other transfer payments, and partly because of the much lower economic growth that resulted.

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As a result, by 1982 Japan's annual deficit amounted to nearly 30 percent of its budget, and interest payments on the national debt accounted for 14.3 percent of the annual budget (compared with 12 percent in the United States).

With its budget deficits, the Japanese government has become a strong competitor in the nation's capital markets and for the nation's savings. Although the government's large deficits alone have not been responsible for the country's stagflation and lower rate of economic growth in the 1970s and early 1980s—the oil shocks of 1974 and 1978 had a dramatic effect on the Japanese as well as world economy—it is clear that government overspending and heavy borrowings have contributed to the much lower growth rate in recent years and have dampened future prospects.

Government Targeting

Financial Aids

Considering the relatively restricted budget the Japanese government officials had to deal with, at least until the early 1970s, and the severe, sometime vicious, political infighting for shares of that budget by the different ministries and political leaders of various regions and interest groups, it is difficult to see how any single group, particularly manufacturing, could have repeatedly secured a large portion of Japan's annual budget. As a matter of fact, in terms of its ability to gain a slice of the small budget pie, the Japanese manufacturing sector has been one of the country's least effective political groups.

Consider the situation following World War II. Because food was scarce, and because more than 50 percent of Japan's population was engaged in agriculture in 1947, the government's main priority was to increase agricultural production and support farmers politically. In subsequent years this support for the agricultural sector has not diminished, but rather has intensified in terms of both relative and absolute amounts of government expenditures. Considering that only 16 percent of Japan's land is arable, government spending of about $10 billion in 1982 indicates very large subsidies for Japanese farmers. The amount was about 54 percent of Japan's total farm income.

Also emphasized after the war were the national railway system, ports, roads, airports and other so-called infrastructure projects. The continued large deficit of the JNR, accounting today for some 18 percent of the nation's annual budget (see Drucker 1982), is evidence that a large portion of Japan's budget has been allocated perennially for the nation's infrastructure.

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Regional development programs, especially for backward places on Kyushu, Shikoku, and Hokkaido islands, have always been well-funded because of political considerations that emerged immediately after World War II. Small-business groups, such as retail shopowners, have also enjoyed strong political bases and have received substantial government support.

In view of the pressure from various politically powerful groups, it was almost impossible for government officials to provide any appreciable amount of direct financial support to the manufacturing sector, especially from the general account budget. MITI received only 1.6 percent of the initial government budget for fiscal 1983. Manufacturing has been one of the least powerful political lobbies and one of the least committed to government aid.

The Fiscal Investment and Loan Program

Apart from the general account budget, the Japanese government uses what is known as the Fiscal Investment and Loan Program (FILP) in order to invest in both government enterprises and selected private industries.

The principal sources of FILP (about 80 percent in 1981) are the government's postal savings and postal insurance systems, with other government insurance activities making up the balance. The allocation of FILP funds is spread roughly among three areas: local government (about 20 percent), public investment (about 30 percent) and policy-implementation financing (about 50 percent). Needless to say, the funds for local government and public investment have little connection to the targeting or development of certain manufacturing industries.

The appropriate question is how the so-called policy-implementation financing has been allocated. Nearly 75 percent of these funds were disbursed for small business loans, housing loans, agricultural and forestry loans, overseas economic cooperation funds, and other miscellaneous uses. It seems clear that most of the funds disbursed by policy-implementation financing institutions are allocated by political or social considerations, rather than for consciously planned targeting of specific manufacturing industries. Of course this is typical of governments everywhere.

The only loans of this type that could be said to have any connection to Japan's industrial policy are the funds disbursed to the Export-Import (Ex-Im) Bank and the Japan Development Bank (JDB). Even so, the Ex-Im Bank and JDB receive only 15 percent and 10 percent respectively of the total policy-implementation financing funds.

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It is plausible that Japan's Ex-Im Bank, by financing export promotion, has been quite helpful for certain manufacturing industries, particularly those with heavy industrial products such as merchant ship industries. Yet, considering the relatively small amounts involved, Ex-Im bank loans cannot be a significant force either for Japan's industrial development or in its exporting. Moreover, practically every industrial nation subsidizes export finance, some to a far greater degree, so Japan's Ex-Im bank is not unique.

It is true that MITI has targeted certain industries with the relatively few funds allocated to the JDB (about 10 percent of policy-implementation financing institutions). But it is highly significant to learn the kind of industries MITI has targeted over the last 30 years. Although there is a variance depending on the stage of Japan's economic growth, Table 1 shows that until the early 1970s, the majority of JDB's low-interest loans went to the development of ocean shipping (including shipbuilding), resources and energy-related industries (coal mining, hydroelectric plants and oil refineries, LNG power generating plants, and nuclear plants), and development loans. In the last ten years the JDB has emphasized investment for environmental quality control and urban development, in addition to energy and regional development.

Although it may be argued that these investments have produced worthy benefits for the Japanese society and economy as a whole, it is extremely difficult to show how any of them have been responsible for the high growth of Japan's manufacturing companies.

Table 2 gives a detailed distribution of the JDB's loans among nonmanufacturing and manufacturing industries during 1976 to 1980. There is no evidence that manufacturing industries in general, or any particular manufacturing sector, have been targeted by the JDB. In fact the share of loans that manufacturing industries have received from the JDB is less than 30 percent.

In summary, under restricted government expenditures, the overwhelming bulk of government financial support in Japan has been distributed to politically powerful groups and to those areas appearing to exhibit the greatest need, such as agriculture, fishing, forestry, the infrastructure, and regional development. Even those funds of the JDB that were designated explicitly for targeting private industries have been disbursed mostly to nonmanufacturing sectors of the economy. In other words there is simply no evidence that the Japanese government's "vision" or "administrative guidance" was followed by any significant financial assistance for the development of manufacturing. Virtually all of the investment capital used by the

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TABLE 1

PROJECT AREA SHARES OF NEW LOANS BY THE JAPAN DEVELOPMENT BANK
(Percent)

Project Area	1951–55	1956–60	1961–65	1966–70	1971–75	1976–80	1984[a]
Resources and Energy	42.8	39.0	16.8	11.5	10.6	25.6	38.4
Development of Technology	0.4	4.5	8.4	11.0	11.5	11.2	7.1
Ocean Shipping	23.4	27.3	30.0	35.4	17.7	7.2	10.0
Urban Development	0.6	1.8	4.1	11.0	17.2	16.7	18.2
Regional Development	—	3.4	18.1	15.9	15.3	14.8	11.5
Improvement of Quality of Life	0.3	0.2	0.5	1.3	21.7	19.7	11.1
Other Development Loans	32.5	23.8	22.1	13.9	6.0	4.8	3.7

[a]Outstanding loan shares as of March 31, 1984.

SOURCE: Japan Development Bank, *Facts and Figures About the Japan Development Bank*, 1981 and 1984.

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TABLE 2

JAPAN DEVELOPMENT BANK LOANS BY INDUSTRY

Industry	New Loans (10^9 Y)[a] 1980	1976–80[b]	Distribution (%) 1976–80
Nonmanufacturing			
Agriculture and Fisheries	4.0	9.3	0.44
Mining	9.8	31.6	0.73
Construction	2.6	20.7	0.48
Wholesale and Retail Trade	9.9	84.6	1.95
Real Estate	30.7	287.5	6.62
Transportation and Communication	216.8	803.3	18.51
Electricity, Gas, Thermal, and Water Supplies	419.7	1,511.9	34.83
Services and Other Nonmanufacturing	72.9	364.0	8.39
Subtotal	766.4	3,122.9	71.95
Manufacturing			
Foodstuffs and Beverages	6.9	58.0	1.34
Textile Products	7.8	39.3	0.91
Pulp, Paper, and Related Products	7.5	47.7	1.10
Chemical Products	29.0	271.1	5.00
Petroleum Refining	47.0	220.6	5.08
Ceramic, Stone, Clay, Glass, and Related Products	29.8	87.3	2.01
Iron and Steel	33.7	258.0	5.94
Nonferrous Metals	10.4	61.0	1.40
Fabricated Metal Products	6.7	26.3	0.61
General Machinery and Apparatus	3.8	15.8	0.36
Electrical Machinery and Apparatus	14.7	42.6	0.98
Transportation Machinery and Equipment	4.2	68.7	1.58
Other Manufacturing	5.5	75.4	1.74
Subtotal	207.0	1,217.8	28.05
Total	973.4	4,340.7	100.00

[a]In billions of yen.
[b]Loans for the 1978–80 period are cumulative: They reflect the total amount of new loans for these fiscal years.

SOURCE: Japan Development Bank, *Facts and Figures About the Japan Development Bank*, 1981.

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rapidly growing manufacturing sectors of Japan were provided by private financial institutions.

Tax Policy

If Japanese manufacturing firms received no significant financial support directly from government, or from government financial institutions, is it possible that they received some favorable tax policies that helped them to compete and grow?

As discussed earlier, Japan was determined for several decades to keep a tight lid on government spending. As a result the nation has been able to maintain the lowest ratio of taxes (national and local) to national income of all the countries belonging to the Organization for Economic Cooperation and Development (OECD). Thus tax policy has been clearly oriented toward economic growth, which some might see as indirectly supporting industrial development, particularly that of manufacturing industries.

The question is, first, did the Japanese government target specific manufacturing industries or companies with special tax measures? And second, if so, did the special tax treatment really help these industries?

During the early 1950s there were some special tax measures passed with the intention of promoting economic growth. These did not last, however, mainly because other entrepreneurs who were not benefiting from them invariably demanded similar measures. Consequently the government was gradually forced either to distribute all such tax benefits equally to all industries, large or small, or to end them completely (Patrick and Rosovsky 1976, p. 353).

In conclusion, it is very difficult to show how special tax measures have played a significant role in Japan's overall economic growth and industrial development. A Hudson Institute report on *Japanese Industrial Development Policies in the 1980s* (Wheeler et al. 1982, p. 104) concluded:

> [T]he total benefits provided by such narrowly targeted measures are small compared with other, less narrowly targeted special tax measures. Moreover, total estimated tax losses from special taxation measures are much less than comparably estimated tax losses from the promotion of saving and investment through such general measures as the exclusion from taxation of interest income on postal savings and of capital gains income on securities transactions.

Import Protection

In addition to government-provided low-interest loans and special tax measures for targeted manufacturing industries, import

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restrictions on foreign goods in key industries have often been alleged to be the reason for that nation's growth. During the 1950s and early 1960s, the Japanese government did exercise strict control over international trade and currency exchange. In 1962, for example, Japan had 492 different products under the import quotas. But Japan's policy was not exceptional during this period. Western Europe and the United States also imposed quantitative restrictions on many items and sometimes discriminated directly against Japanese manufacturing products.

The pertinent question for this paper, however, is whether the Japanese government imposed tariffs, quotas, and other restrictions in order to foster targeted manufacturing industries. There seems to be no clear evidence that favoring specific manufacturing industries was a main objective of exercising strict control over foreign trade and exchange dealings, especially during the 1950s and most of the 1960s. Rather the main consideration for the Japanese government was maintaining the value of the yen and a favorable balance of payments.

Because, in the postwar era, the country had to import almost all its raw materials and agricultural goods, and had no international reserves or many products to export to pay for raw materials, there seemed, to officials at that time, no alternative to restricting imports. Later in the 1950s and early 1960s, as industrial production and consumer incomes grew rapidly, the demand for fuel, industrial materials, technology, industrial machinery, and consumer goods from abroad grew much faster than export capability. This resulted in a chronic balance-of-payments deficit.

In 1955 Japan was readmitted to the international "club," the General Agreement on Tariffs and Trade (GATT). Because government officials wished to regain respectability in the international monetary and trade communities, they adamantly committed themselves to maintaining the value of the yen (reestablished in 1949) at the fixed-exchange rate, instead of constantly devaluating the yen. Also, because government officials were reluctant to borrow significant amounts of money from abroad, the government was overly sensitive to the nation's balance-of-payments disequilibrium. In other words the Japanese government slowed down the rate of growth of its economy through monetary policy, not because of domestic inflationary pressure, but because of perceived balance-of-payments problems.

The Brooking Institution's study (Patrick and Rosovsky 1976, p. 219) pointed out that "Japanese recessions have been the direct and deliberate result of monetary policy action taken to slow down

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a rate of growth considered too fast because it had created or threatened to create balance-of-payments problems." The Japanese government rightly or wrongly chose to maintain selective import restrictions or to substitute imports of manufacturing goods as much as possible, rather than be forced to frequently apply a restrictive monetary policy which might slow the expansion of aggregate demand and GNP, while creating recession and uncertainty in the business community.

Many economists believe that, had Japanese officials not been overly concerned about a negative balance on current account or so concerned about controlling imports, Japan might have enjoyed a even faster rate of economic growth during the 1950s and 1960s (Patrick and Rosovsky 1976, p. 171). To put it simply, government protectionist policies on imports, while of great benefit to some industries, were probably not a positive factor in Japan's overall economic and industrial development.

Needless to say, when Japan's international competitiveness had improved and the nation began experiencing chronic surpluses in its balance of payments, Japan's policies of import restriction were drastically reduced, although Japanese officials were still concerned about the balance-of-payments situation. Professor G. C. Allen wrote in *How Japan Competes* (1978, p. 48):

> Foreigners who fasten their eyes on Japan's present huge surplus forget that for the first 25 years after the war her recovery and expansion were constantly under threat from the precarious state of her balance of payments. This weakness had its source in the failure of her export trade to keep pace with her industrial growth. It is only within the last 10 years that she has earned a substantial surplus on her current account. Even in that period, as a result of the sudden rise in oil prices, her account for two years showed a large deficit. . . .They are aware that a change from surplus to deficit may occur unpredictably and suddenly in a world of rapid technical progress, capricious markets and political instability.

Targeted Industries

It would be wrong to claim that no Japanese industries have benefited from subsidies, low-interest loans, or import protection. There are numerous industries that have capitalized on the opportunities provided by these policies. Nonetheless a more pertinent question in this instance is whether or not the industries that have been most heavily targeted, supported, and protected by the government really have prospered in the long run as much as industrial-policy proponents have claimed.

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Agricultural Industry

As discussed earlier, for both social welfare and political reasons, the Japanese government has heavily subsidized farmers with higher prices and income supports, and has provided substantial protection for agricultural products from import competition. Today Japanese agriculture is by far the largest and most inefficient industry in Japan, and the most conspicuous contributor to the large budget deficit of the nation.

Coal Mining Industry

Coal mining is another industry to which the government has allocated relatively large amounts of low-interest loans through the JDB. Before World War II Japan's coal mines and hydroelectric plants supplied nearly all the power required domestically. It was, therefore, a logical policy for the Japanese government to emphasize the production of coal after the war. Also, of course, the coal mining industry was politically powerful.

Yet, despite the government's positive support during the 1950s and 1960s, the output of domestic coal decreased sharply from 54 million metric tons in 1962 to 19 million metric tons in 1978. The coal mining industry has been gradually phasing down.

Petroleum Refining and Petrochemical Industries

Petroleum refining and petrochemical production have had the special advantage of direct government assistance and protection. They have received favorable tax treatment for the licensing of foreign technology, foreign-exchange allotments for purchasing equipment, indirect subsidies through tariff schedules, and the provision of land at nominal prices in the postwar period, particularly in the early 1960s.

These government interventions and an administrative-guidance in the lucrative oil refining business (including production of naphtha) and petrochemical production (mainly production of ethylene) occurred without careful market, financial, competitive, or other economic considerations. The excessive capacity of these industries today results, at least in part, from government control and intervention.

The government-backed oil refining industry of Japan has had a guaranteed market selling naphtha products to the government-protected petrochemical industry at a price higher than the world market. When the Japanese economy was growing rapidly and the industry was relatively competitive in world markets, the Japanese petrochemical industry appeared to be very successful. However, when the price of oil rose and the world petrochemical market become

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more competitive, Japanese petrochemical production become uncompetitive. The petrochemical industry demanded that the government allow a much larger quantity of cheaper naphtha to be imported in order to make ethylene more competitive. The government's dilemma has been that allowing an increase in imports would deny the protected Japanese oil refining industry any market, domestic or international. On the other hand the Japanese petrochemical industry will not be able to survive without cheaper naphtha from international sources.

Shipbuilding Industry

In the 1950s, recovering from a military defeat and rejoining the international market, Japan established various forms of special supports for its shipbuilding industry in the form of tax benefits, low-interest and deferred loans, and financing through the Ex-Im Bank and the JDB. These government subsidies were continued for most of the 1960s, and by 1970 shipbuilding in Japan appeared to be very competitive in world markets.

With the first oil shock of 1973, however, the government-supported shipbuilding industry began to exhibit its real character. Facing serious problems of excess capacity, along with the decline of world demand, particularly for oil tankers, and the growing, very severe competition from developing nations, Japanese shipbuilders were forced to scale down by shedding 46,000 workers after 1977. Today the industry has had to reduce its operating ratio to 35 percent of total capacity, with some 19 companies failing between 1975 and 1978 (Wheeler 1982, pp. 165–70).

In conclusion the Japanese government, like other governments, has tended to support both politically powerful sectors (such as agriculture) and comparatively disadvantaged sectors (such as energy-oriented industries) without considering their efficiency or competitiveness. In other words Japanese government officials, many of whom are able bureaucrats, have not solved domestic industrial problems through the political process. Even in Japan, government attempts to allocate capital resources have created inefficiency and excess capacity in the private sector.

In stark contrast to the above-mentioned industries, Japan's most successful and internationally competitive industries have received relatively much less financial assistance and/or much less protection from the government.

Computer-Related Industry

The computer-related industry (including semiconductors) is often cited as a model case in which Japanese industrial policy has worked

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well in recent years. Yet it is very difficult to point out unusual government support in terms of government expenditure, JDB loans, or tax advantages. For example the Japanese government's R&D expenditures in the semiconductor field have been far less than half of the U.S. government's expenditures in the same area. According to the *Journal of Japanese Trade and Industry* (1983), Japan spent $127 million in the 1976–82 period while the United States allocated $279 million in the shorter 1978–82 period. The JDB's low-interest loan (about 1 percentage point below the commercial bank rate) of Y10 billion in 1982 was equivalent to less than 0.5 percent of the total plant investment by the electronic machinery industry.

Automobiles and Consumer Electronics Industries

Automobiles and consumer electronics, two of Japan's most visible and successful industries, have enjoyed "practically" no special government favors. The *Nippon Keizai Shimbun (Japan Economic Journal)* reported in July 1983 that the automobile industry (mainly parts makers) received about Y77.9 billion ($327 million; Y240 = $1) in long-term loans from the JDB in the last 25 years.

Government and Business Cooperation

It is true that in Japan government officials engage in an extraordinary amount of consultation, communication, and mutual discussion with business groups. It is also true that Japanese businessmen respect government officials. However this does not in any way mean that the thousands of Japanese entrepreneurs and corporate executives invest their capital, hire their workers, select new technologies, or adopt new marketing strategies by consulting government officials. Nor do they operate their businesses according to any government-proposed vision or administrative guidance.

The majority of business executives in Japan could not afford to operate their businesses by close consultations with government officials, since there exists fierce competition and rivalry for their market shares, both domestically and internationally. Large and small firms, and groups of affiliated firms, fight hard to increase their market shares and industry rankings. Naturally, firms that are not at the top are intensely motivated.

Japanese entrepreneurs are also well aware that government officials do not possess knowledge about future economic changes that is superior to that of the private sector. Indeed they recognize that the ability of Japanese bureaucrats to plan or manage enterprises is not better than that of those in the marketplace, nor is it better than that of other governments, including socialist nations.

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In judging the managerial ability of government, one should consider the governmentally owned JNR. Even though officials who manage the JNR are as bright and as talented as other officials in government, such as at MITI, JNR, Japan's largest employer (with over 400,000 workers), is very overstaffed. It has several times as many employees per revenue mile as any other railroad system in the industrial nations. It cannot handle the most combative and strike-prone labor union in Japan; and its deficit accounted for 18 percent of Japan's 1980 budget. Most private railway systems in Japan, on the other hand, have been very well managed and profitable.

In addition to the government's apparent lack of managerial skill in its own enterprises, government officials have had to deal with the fact that most private businessmen (especially Osaka businessmen) are suspicious of government authority. They tend to avoid government assistance, and even avoid contact with government officials as much as possible. Unless government intervention has happened to be in their business interests, the business community has strongly resisted government pressure. For example throughout the 1960s, MITI, concerned about the lack of competitiveness in the automobile industry, tried to consolidate many automobile companies into a few large companies. Only strong resistance by Mazuda (Toyo Kogyo), Honda, Mitsubishi, and others forced MITI to drop the attempt. The fact is the Japanese government has not been free to intervene heavy-handedly in the private sector.

Administrative guidance by MITI has been effective only when MITI has had the power to provide considerable financial benefits to the industry or when all companies in the industry have reached some kind of consensus. For example, when the oil refining industry was under MITI's control through the price-cartel system and the quota system for imported crude oil, it tended to follow government guidance. Yet government officials have faced difficulties in dissuading all the firms from expanding their refining capacity.

Moreover, in recent years, deep conflicts of interest among different industries have emerged. Often, government officials have been caught in the middle between these conflicting interest groups, such as in the cases of yen revaluation (import-oriented versus export-oriented industries), pollution control laws (clean industries versus polluted industries), voluntary restriction of exports (government or foreign policy versus industries), and others. In democratic societies such clashes of interests have always been the source of tension and real obstacles to the building of any national consensus. This has been as true in Japan as anywhere else.

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The Market Mechanism in Operation

How then did Japan accomplish its phenomenally high economic growth rate after World War II? The "secret" of Japan's growth can be stated in the simplest terms—a basically free-market economy, functioning effectively with minimal government intervention since the war. With the collapse of Japan's traditional feudal society, and the emergence of a more open society, came a dramatic unleashing of creative energy and dynamic forces. Japan now has a freer and more democratic political and economic environment than in the prewar period. It has freedom of occupation, free speech, freedom of investment and pricing, and protection of other fundamental human rights. Individuals freely can seek to maximize their capital, talents, choices, and ideas. Under the American occupation, many of the old leaders were purged and the old order was reformed. Cartels, such as Zaibatsu, were dissolved, and private busineses were substantially freed of government control and intervention. For the first time practically any Japanese, regardless of age, class, or family background, could venture into business, and succeed if the elements of hard work, imagination, willingness to take risks, and luck were present. Not only did established businesses prosper under fresher and younger management in this freer environment but thousands of entirely new enterprises, such as Honda, Yamaha, Sony, and Suzuki, to name but a few, were born in this new climate.

In Japan's free society nationwide competition and sometimes fierce rivalries were preserved, requiring corporate executives to make forward-looking investments to keep equipment and technology up to date. In macroeconomic terms these competitive investments by private entrepreneurs created demand and called forth yet more investment. Japan took a huge leap in economic expansion, and a high ratio of capital investment to national income was established. Moreover the fierce domestic competition led to the refinement of management techniques and higher quality goods. In short, individual entrepreneurs invested in capital goods and equipment, not because MITI officials suggested it, but because they foresaw the potential for future profits by besting their competition in both domestic and foreign markets.

Through the market process—hundreds of thousands of private entrepreneurs' individual decisions and energy—rather than by the government's calculated direction, Japan's industrial structure has shifted to high value-added manufacturing industries.

Naturally, economic growth never proceeds without some industrial disequilibrium. In the 1950s Japan lacked technology and

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capital, but with an abundance of cheap labor, the labor-intensive manufacturing industries—textiles, ceramics, woodworking, foodstuffs and beverages—accounted for over 35 percent of output (value-added) in the manufacturing sector. These industries employed about half of the total labor force employed in Japan's manufacturing industry, and were also responsible for the exports (about 50 percent of total export trade) in the mid-1950s that brought precious foreign currency into the country. Such exports were vital for the acquisition of raw materials, foreign technology, and managerial know-how, all of which enabled other kinds of manufacturing to evolve and grow.

Even during the 1960s, these industries played an important role in production and trade. But during the same period, capital-intensive and high-productivity industries began to emerge. They grew quickly as new firms entered and older firms deliberately shifted resources into more capital-intensive products. Through this market mechanism, Japan's industrial structure was transformed as older industries—though continuing to grow in absolute terms with fewer companies than before—were replaced by new, high value-added manufacturing industries, which produced such products as cameras, television sets, motorcycles, and automobiles.

Obviously the success of Japan's economy could not have been achieved without certain favorable international conditions, such as the existence of inexpensive raw materials (expecially petroleum), stable and open world markets for Japanese goods, and readily available foreign technology. But it should be emphasized again that it was not the Japanese government or MITI that created these conditions. Nor can MITI claim more than occasional credit for the successful exploitation of preexisting conditions. Rather, Japan's success in international markets was the work of thousands of private firms, especially the trading companies. These private firms aggressively entered world markets as importers of raw materials, exporters of Japanese products, and negotiators for advanced technologies and know-how. Vigorous private traders, not government officials, have been a major source of Japan's economic strength both in the world market and at home.

In addition to favorable domestic and international environments for Japanese entrepreneurs, it is important to remember the abundant and well-educated labor force of Japan. These workers (including well-trained engineers and devoted managers, and competent technicians, well-equipped to assimilate and apply the know-how imported from abroad) have been a key ingredient in the success of Japanese economic growth and manufacturing industries today. These workers are disciplined and hardworking, adapt easily to new technology,

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and are both willing and able to help management develop new ideas and techniques. They also save approximately 20 percent of their income, thereby fueling future investments in their country's progress.

The question often arises as to why Japanese employees should exhibit these traits. The answer is, in large part, the same as for the entrepreneurs: An environment was created after World War II in which millions of individuals, regardless of their social backgrounds, could by their own efforts achieve better, more prestigious positions in society, and, at the same time, enhance their own material well-being.

Competition for obtaining a good position and advancement is fierce, and those who acquire the highest quality education possible (mainly by attending Japan's finest universities) have the best chance to get ahead. Most parents are willing to pay the high price of preparing their children for the entrance examinations. Because such preparation is expensive, they tend to put away regularly a large percent of their income for their children's future. Thus the twin goals of a better educated labor force and greater national savings are served.

Another important motive for savings could well be the inadequacy of the government's social security, welfare, and public housing programs. This inadequacy forces individuals and families in Japan to provide for their own security after retirement and during illness and unemployment, and to secure their own housing.

The drive of individuals to provide for their own and their children's security and housing helps explain why, once recruited by a company, they are likely to devote themselves to that company for life (around 55 to 60 years old). The workers also know very well that their present and future well-being depends on the success of their employers in what are usually highly competitive markets. Consequently they are eager to contribute their energy to the corporation, and are very willing to focus on long-term benefits rather than short-term gains from labor negotiations.

By the same token, loyal and talented workers are just as indispensable as equipment to their companies. So Japanese entrepreneurs are motivated, for purely economic reasons, to invest in the development of their human resources. In order to recover the maximum worth from this investment in human capital, companies generally try to retain workers instead of discharging them, even when under economic stress. But even in Japan, unskilled workers are not awarded lifetime contracts. They are discharged according to the

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economic situation. Close labor-management cooperation, therefore, cannot be explained solely by Japan's cultural traditions, and certainly not by active government involvement. It is a result of clear-sighted economic practicality and a free labor market.

Not unrelated to this successful labor-management cooperation—and, indeed, to the export success of Japanese products—is the fact that Japanese entrepreneurs, beginning early in the 1950s (when "Made in Japan" was still an epithet), have had a firm commitment to quality control. American experts in statistical quality control, such as Dr. W. Edwards Deming, have had far more success with the top management of Japanese manufacturing firms than they ever had with corporate executives in the United States. In fact, for over 25 years, the annual Deming Prize, offered to the companies that achieved the most progress in this area, has been one of the most prestigious and sought-after industrial awards in Japan.

This commitment to statistical quality control by both top management and labor has had deep implications. Exacting specifications by companies selling consumer or industrial goods means that suppliers to those companies are also required to practice and achieve statistical quality control. As a result such methods, which are far more effective and significant than simply sorting final assembly-line products, are common practice in Japan and, along with some labor-management techniques such as "quality circles," are now being touted for the United States.

In Japan the concept of statistical quality control generally means not only quality assurance but also cost reduction and higher productivity. Most competitive and successful companies in Japan are deeply committed to reducing their production costs and to improving their productivity and quality through a company-wide statistical quality control (also called total quality control) method.

The implementation of this method was initiated solely by private businessmen. It has been intensified under the great difficulties perceived by Japanese entrepreneurs since 1970, namely a more than 30 percent appreciation of the yen after the "Nixon shock" of 1971 and the two oil shocks of 1973 and 1978. This almost fanatical commitment to high productivity and quality control by Japanese entrepreneurs could be a major reason why Japanese manufacturing goods are still competitive in the international market. It also may explain why Japan again has a trade surplus today, despite the fact that Japan's terms of trade have deteriorated greatly because of the steep rise in oil prices.

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Conclusion

It is true that the Japanese government contributed to the enormous economic success of Japan after World War II, especially during the 1950s and 1960s. Ironically, however, the government contribution is based not on how much it did for the economy but on how much it restrained itself from doing. Its interference in the economy was sporadic and slight, including efforts aimed at industrial development.

But by maintaining a small and balanced budget, fairly low and stable interest rates, relatively low rates of taxation, stable prices, brief and mild recessions, minimal defense and social welfare expenditures, the Japanese government helped provide an exceptionally favorable economic environment for private enterprise. Moreover, by maintaining the political stability necessary to promote private investment, the government contributed even further to increased economic growth.

To be sure, international factors aided Japan's economic success, but credit must go to those who capitalized on this favorable environment and spurred the country's economy into much higher economic growth than Japan ever experienced before the war. These were the hardworking, educated, imaginative, private entrepreneurs in cooperation with millions of workers. Together they developed efficient, productive, and competitive manufacturing industries. G. C. Allen wrote in *The Japanese Economy* (1981, p. 91): "The chief function of the bureaucrats and politicians was to provide a congenial environment for the enterprise of private firms. The state may have built the furnaces; private entrepreneurs (companies, groups and individuals) supplied the fuel. It was these entrepreneurs that, in large measure, determined Japan's economic future."

In the field of industrial development, the Japanese government, mainly MITI, has extended special supports—mainly low-interest loans and import protections—to certain industries for balance-of-payments, political, and national security reasons, especially during the 1950s and 1960s. Although some of these industries appeared to be successful under favorable international conditions, they are in fact not competitive in world markets. In recent years they have shown themselves to be depressed industries in a competitive international environment. The government is currently helping these depressed industries. But the government is not trying to keep them all alive with high government expenditures or stiff import protections.

Because of the two oil shocks and a recent worldwide recession, many businesses in Japan have been facing the same difficulties as

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those government-aided industries. However, these private companies are confronting reality with the full cooperation of their workers. They have striven to reduce energy consumption, to improve productivity, and to enhance the quality of their products without government assistance. It is these manufacturing industries that are maintaining Japan's competitive strength in international markets and, as in the past, providing a source of economic growth.

During the last 10 years the Japanese economic growth rate fell drastically (by 4 to 5 percent). At least partial responsibility for this lies with the two oil shocks. In addition the relative shortage of technology, greater difficulties in recruiting a young labor force, and the transformation of the daring and aggressive entrepreneurs of the 1960s into the more staid and conservative business leaders of the 1980s could be additional reasons for Japan's slower growth rate.

One of the most negative influences on Japanese economic vitality since 1970 has surely been the vast expansion of government expenditures, complete with huge budget deficits. This government involvement in the financial market today will likely produce a very unfavorable economic environment for the private sector in the future. This will be an environment in which economic growth will be slow at best, especially when the government is forced to raise taxes or inflate the currency to cover the nation's accumulated deficits.

In a market-oriented economy like Japan's, government support in the form of subsidies to targeted industries is rarely a vital ingredient in the nation's general economic growth, even though it may be temporarily beneficial to the favored industries. In such an economy, government policies in the macroeconomic area tend to influence economic growth far more profoundly than does any selective industrial policy.

History reveals an unblemished record of failure by governments to improve on the market. While Japan's economic success over the past 30 years has indeed been accompanied by activities aimed at promoting industry, it would be a very serious mistake to conclude that there must have been some critical cause-and-effect relationship. As the facts demonstrate, Japan's success has been in spite of, rather than because of, government tinkering.

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"JAPANESE ECONOMIC SUCCESS": A COMMENT

Philip H. Trezise

Japan's industrial policy has been the subject of an impressive amount of recent commentary in the United States. Most of the comment has attributed Japan's economic success in whole or in large part to the application of industrial policy measures. Views diverge, however, when the implications of industrial policy are assessed. One camp enthuses over the discovery that a democratic government seemingly is able successfully to guide, direct, and manage a big, modern economy in a detailed fashion. Another group is in a state of alarm about the grave threat that industrial policy in Japan is believed to pose for the American commonwealth.

Katsuro Sakoh (1984) has taken still a third position, which is one of broad skepticism about the influence and accomplishments of industrial policy in postwar Japan. I associate myself with Dr. Sakoh, for I have long believed that the microeconomic role of the civil service in Japan's postwar miracle has been greatly overstated. There are a large number of reasons for this, one being that some of the claims made for industrial policy offend common sense. Dr. Sakoh's paper raises several fundamental considerations that are commonly ignored both by enthusiasts for industrial policy and by those who consider Japanese policy to be a mortal danger.

Thus he takes exception to the view that a cadre of civil servants have been able to steer Japan's captains of industry into lines of endeavor that would otherwise somehow have been overlooked. The influence of Japan's bureaucracy is not to be dismissed, to be sure, for law and tradition have invested officials with greater authority and claim to respect than we would think necessary or justified. But Japan's is an extremely large and varied economy. If all major decisions in the private industrial sector had had to wait on consultation

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with the relevant Ministry of International Trade and Industry (MITI) bureau chiefs, the economic miracle would have had a short life indeed. Dr. Sakoh remarks, as did the late William Lockwood, by far the wisest of the foreign students of Japan's economic development, that Japan's private businessmen typically will resist or evade unpalatable government directives. Where the government has favors to offer, on the other hand, bureaucratic intervention can be accepted or adapted to. The bargaining and compromises that go on between business and government are part of Japan's market economy. And in the end, the specific choices as to where, when, and how productive resources are to be used are made by the private sector.

Another of Dr. Sakoh's points has to do with the official subsidies that reputedly are lavished on Japan's industries. One should not be misled by talk of billions of yen, which translate into a small number of millions of dollars. The facts are easily come by. Japan's budgets are public documents. Subsidies to the private sector go overwhelmingly to agriculture, small business, and in recent years to various kinds of energy projects. The Japanese National Railways, as Dr. Sakoh notes, are a fourth and voracious claimant for public monies.

After these more or less irresistible demands have been met, the fiscal watchdogs in the Ministry of Finance's Budget Bureau are not given to excesses of generosity for others. MITI had a budget authority in 1980 of about 650 billion yen—say, $3 billion—to cover its personnel costs, its laboratories, its share of the energy program, and everything else. The Ministry of Agriculture's budget was 3.8 *trillion* yen, of which rice subsidies alone came to 955 billion yen, almost half again the size of MITI's allocation.

Subsidies include publicly financed research and development (R&D). Japan is not only the most niggardly of all the big industrial powers in spending on R&D but it also directs a larger fraction of what it does spend to grants to universities with relatively few strings attached. It also devotes a larger share of its R&D budget to agriculture than do other industrial nations.

A third point which emerges from Dr. Sakoh's paper has to do with the proposition, implicit in much of the industrial policy literature, that in Japan noneconomic or vulgarly political considerations never intrude on the decision-making process. What has been said about subsidies should pretty well dispose of that piece of mythology. A government focused narrowly on economic efficiency would never have made rice growing a highly remunerative occupation or allowed to survive unaltered an overmanned and heavily loss-making railway system.

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The allocation of direct subsidies to politically sensitive sectors is one thing. Tax policy, similarly, is not aimed, in rifle-like fashion, at a few carefully selected, highly promising industrial targets. Rather tax benefits are scattered widely over the economic scene. One of the principal recipients is the medical profession, which is the beneficiary of about 14 percent of what the Ministry of Finance calls revenue losses. The reason: The doctors in their organized manifestation have pursued with much vigor a grievance over the low fees paid under the national health insurance program. Small business is favored, as are investors in depressed areas and coal mining regions. Japanese airlines get special depreciation allowances for planes, none of which are produced in Japan. Here and there, of course, one finds among the special tax measures benefits for a new or emerging industry, robotics for example. In the main, nonetheless, the tax system tends like our own to be responsive to a wide range of large and small political requirements. This should be surprising only to those who forget that Japan is among other things a lively political democracy.

The putative devotion of the bureaucracy to purely economic objectives is questionable otherwise. Industrial or microeconomic policy in Japan has always been infused with a strong flavor of quite narrow nationalism. Restrictions on foreign direct investment persisted well into the 1970s, based ostensibly on balance of payments considerations. The record makes it clear, however, that to a substantial extent the policy reflected a not especially reasoned fear of having a foreign economic presence in Japan. MITI's unusually detailed interventions in the affairs of the petroleum refining industry had somewhat related origins. Similar attitudes have been evident in other industrial nations but nowhere with so heavy an impact on economic policy. This near-wholesale rejection of foreign investment could not have been economically costless, whatever the psychic gains it provided.

It seems to me that a closer look at what happened and is happening in Japan should help to dispel the mixture of admiration and fright that pervades American discussion of Japanese industrial policy. The sources of Japan's remarkable economic achievements after World War II's military debacle are numerous. Dr. Sakoh's emphasis on the favorable environment for private enterprise touches on an absolutely basic point. Luck plus a dedicated adherence to a dogma that suited Japan's special situation helped to make macroeconomic policy work exceptionally well, until a panic response to the forced yen revaluation coupled with the world commodity inflation upset everything. Edward Denison has described and analyzed better than

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anyone else the fundamental supply-side forces that made possible the 1951–73 growth miracle. Extensive intervention by MITI, principally in *one* economic sector, manufacturing, was certainly a part of the total story, but relative to the magnitude of the Japanese accomplishment the resources devoted to so-called industrial policy have been extremely modest. Even if one supposes that the bureaucrats were always wiser than reason and the evidence would allow, it is difficult to accept that industrial policy should be credited with a principal contribution.

Belief in the efficacy of industrial policy is fostered by arguments from the particular. The Japanese automobile's industry successes, which are wrongly attributed to industrial policy anyway, sometimes seem to be taken to represent circumstances in all of Japan's industrial economy. Or the purported effectiveness of one cooperative research project among semiconductor producers is held up as the general case. No similar attention is given, however, to the instance of the video tape recorder, production of which grew from 119,000 units in 1975 to 13 million in 1982, mostly for export. MITI, rightly enough, takes no credit for this truly spectacular development.

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THE CONSTITUTIONAL CHAOS OF INDUSTRIAL POLICY

Edwin Vieira, Jr.

Introduction

As its contemporary advocates employ the term, "industrial policy" imports a peculiar form of governmental intervention in the evolutionary process of the market economy.[1] In its turn, governmental intervention implies legislative statutes, executive orders, administrative rules and regulations, and judicial decisions—which themselves always at least potentially involve, at some stage, considerations of constitutional law. Therefore, judging the appropriateness of any industrial policy requires recourse, not simply to economics, but also to the Constitution.

This article catalogues the major types of industrial policy being promoted today and critically assesses them from the perspective of constitutional law.

A Typology of Contemporary Industrial Policy Proposals

Most of the contemporary proposals for industrial policy that raise significant constitutional issues share certain common features. First, the proposals generally recommend formation of boards, councils, or other official or quasi-official groups representing or subject to the influence of the dominant power blocs of the American "new class": namely (i) politicians and bureaucrats, (ii) businessmen, (iii) leaders of organized labor, (iv) academic and "public-interest" gurus, and (v) doyens of the financial establishment. Second, the proposals enable

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[1]In principle, the government's adoption of a strict laissez-faire approach would constitute an industrial policy. But no significant support for such an approach exists among those generally treated as spokesmen for industrial policy.

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these boards to monitor the performance of the national and regional economies; to collect, analyze, and interpret data thereon; to prepare reports and recommendations for Congress, the president, and administrative agencies regarding what the boards perceive as needs and priorities in the areas of industrial revitalization and innovation; and generally to create an official forum in which spokesmen for the new class can identify purported industrial problems, develop plans for governmental solutions of these problems, and promote a political consensus—or at least arrange political action—in support of implementation of their plans. In some instances the proposals go further, delegating direct authority to the boards themselves to elaborate and implement rules with the force of law. Third, the proposals empower the boards, directly or indirectly through the intermediation of an industrial bank or similar institution, to grant favored private parties subsidies or guaranteed loans financed by taxation, monetary expansion, or the diversion of private pension fund monies from other investments.

The Anti-Market and Elitist Attitudes of Industrial Policy Proponents

Even the most cursory study of the major contemporary proposals for industrial policy exposes a fundamentally anti-market (or anti-individual freedom) and elitist (or undemocratic) strain permeating them. This is hardly accidental, but instead accurately reflects the near-universal attitudes of their most influential proponents. Although the motivations of those advocating, or even taking, governmental action is but rarely and then only with great difficulty of use in constitutional analysis,[2] consideration of these attitudes can illuminate some of the legal issues lurking not far below the surface of today's demands for industrial policy.

The anti-market bias of the exponents of industrial policy reveals itself most strikingly in their view that all economic choice and action in modern society is in fact, and of its very nature must be, political or at least subject to political constraints without logical limit. In economic terms this thesis denigrates market freedom as a myth. In political terms it denies the existence of any individual rights to economic independence that government lacks plenary discretion to qualify, alter, or abolish altogether. And in constitutional terms, it

[2]Generally legislators' motives are irrelevant to the validity of legislation: For example, Communist Party USA v. Subversive Activities Control Board, 367 U.S. 1, 87 (1961); Mulford v. Smith, 307 U.S. 38, 48 & n.19 (1939). See, however, United States v. Constantine, 296 U.S. 287, 296 (1935); Henneford v. Silas Mason Co., Inc., 300 U.S. 577, 586 (1937).

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dissents from the teaching that "[t]he very purpose" of the supreme law is "to withdraw certain subjects from the vicissitudes of political controversy, to place them beyond the reach of majorities and officials and to establish them as legal principles to be applied by the courts. One's right to life, liberty, and property . . . may not be submitted to vote; they depend on the outcome of no elections."[3]

For example, Robert Reich supposes that the "enduring myth of the unmanaged market" has

> sidetracked Americans into endless debate over the relative merits of two highly artificial concepts: the "free market" and "national planning."... Either way, government will be actively involved. And though the form of government involvement may be different, the fact of its involvement will be nothing new. . . .
>
> [O]ur mythic assumptions lag behind our political reality: Every major industry in America is deeply involved with and dependent on government.... *No sharp distinction can validly be drawn between private and public sectors within this or any other advanced industrialized country;* the economic effects of public policies and corporate decisions are completely intertwined.[4]

Because, claims Reich, "any important economic choice is by nature political,"[5] it is not "possible *not* to have an industrial policy."[6] At one stroke, then, Reich obliterates individual freedom—in the sense of an identifiable area of human action not subject to public control—as a meaningful political-economic category. What logically remains thereafter of such constitutional injunctions as that "private property

[3]West Virginia State Board of Education v. Barnette, 319 U.S. 624, 638 (1943). Of course, in the true spirit of the F.D. Roosevelt era, the Barnette Court tempered this principled statement with the weaseling qualification that

> [t]hese principles grew in soil which also produced a philosophy that the individual was the center of society, that his liberty was attainable through mere absence of governmental restraints, and that government should be entrusted with few controls and only the mildest supervision over men's affairs. We must transplant these rights to a soil in which the *laissez-faire* concept or principle of non-interference has withered at least as to economic affairs, and social advancements are increasingly sought through closer integration of society and through expanded and strengthened governmental controls. [Ibid., at 639-40]

The qualification is feckless, however, in so far as "economic affairs" implicate, as they self-evidently do, the "liberty" and "property" that the Constitution protects *in haec verba*. See Vieira, "Rights and the United States Constitution: The Declension from Natural Law to Legal Positivism," *Georgia Law Review* 13 (Summer 1979): 1447,1489–90.

[4]Robert B. Reich, *The Next American Frontier* (New York: Basic Books, 1983), at 232–33; emphasis supplied.

[5]Ibid, at 273.

[6]Reich, "An Industrial Policy of the Right," *The Public Interest* 73 (Fall 1983): 7.

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[shall not be] taken for public use without just compensation"[7] in a society where a "sharp distinction . . . between public and private sectors" is not "vali[d]," Reich leaves unexplicated. The obvious conclusion, however, is that *no* constitutional rights defining a "free market" survive Reich's asserted demolition of that "enduring myth."

The elitist prejudices of the exponents of industrial policy appear most insistently in their complaint that the failure of American political institutions to generate a comprehensive industrial policy demonstrates the incompetence of those institutions and the need to replace them with new governmental structures designed to circumvent the myriad checks and balances of democratic politics in order to impose such a policy on an otherwise unwilling nation. For example, Robert Reich criticizes "all participants in American enterprise" for "hav[ing] taken advantage of opportunities to increase their own economic security at the expense of others." Accordingly, he believes that

> the United States needs a political forum capable of generating large-scale compromise and adaptation—a national bargaining arena for allocating the burdens and benefits of major adjustment strategies. Such an arena would enable the nation to achieve a broad-based consensus about adjustment. It would enable government, business, and labor to fashion explicit agreements to restructure American industry. . . .
>
> Adjustment cannot proceed without mechanisms for explicit bargaining among economic groups and without institutions with the authority to monitor and guarantee the consensus.[8]

Obviously, Reich considers Congress and the courts incompetent to function as the "national bargaining arena" he hypothesizes. Perhaps this is because, for him, *too many* of the "participants in American enterprise" have the political influence, or valid legal claims, to obtain legislation or judicial rulings that favor their interests. For, as Reich emphasizes, access to the new "political forum capable of generating large-scale [economic] compromise and adaptation" must be limited to representatives of government, business, and labor, with the latter two no doubt structured in the "hierarchial mass organizations" he admits "have never found much support" in the "highly contentious," "disorder[ed]," and "opportunis[tic]" political system that heretofore has refused to produce a coherent industrial policy.[9]

[7]U.S. Const., amend. V.

[8]Reich, "The Next American Frontier," *The Atlantic Monthly* 251 (April 1983): 106–8.

[9]Ibid., at 108.

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Reich's vision of industrial policy includes recognition of economic-cum-political groups representing "business" and "labor"; the creation of "mechanisms for explicit bargaining among [these] groups" on the future of American industry; and the empowerment of new political "institutions with the authority to . . . guarantee the consensus"—that is, to enforce the groups' agreements against dissenters, including those who might seek redress in "the cloakrooms of Congress . . . and the courtrooms of every judicial district." Even Reich dimly senses that this substitution of rigidly organized, governmentally sponsored economic-cum-political collectivities for individuals and ad hoc voluntary groups as the basic units of political action in the industrial sphere is inconsistent with the Constitution's requirement that all citizens enjoy formal equality of legal opportunity to influence the governmental decision-making process.[10] Yet he implicitly dismisses the significance of this inconsistency by dogmatically asserting that "mounting pressures . . . *inevitably* are reshaping our governing institutions—consolidating authority over the economy, and *forcing* a closer strategic link between business and government."[11]

Thus the exponents of industrial policy neatly finesse the two major constitutional problems arising from their proposals. That industrial policy collides with principles of individual freedom is merely an apparent problem, they contend, because the free market is largely mythical in any event. And that industrial policy offends traditional ideas of political equality is merely a temporary inconvenience, they explain, because inexorable events will shortly render both those ideas, and the institutions embodying them, obsolete relics of an irretrievable past.

The Fascistic Propensity of Industrial Policy Proposals

The anti-market and elitist attitudes of the advocates of industrial policy crystallize in the fundamentally corporativistic—or, more bluntly put, *fascistic*—structure that permeates the most important contemporary proposals for such a policy: namely, *the tripartite board*, composed of carefully chosen representatives of business, labor, and

[10]Praising "the comprehensive bargaining arena in which West Germany's structural policy is formulated—where industry, labor, finance, and government leaders thrash out workable agreements on wage rates, selective credit policies, and adjustment," Reich nonetheless eschews the German system as "an appropriate model" for the United States. For, he admits, "[t]he relative ease with which a consensus about structural policy has been achieved" in Germany may be a product more of its "recently totalitarian" history than of "institutional design." Ibid., at 107.

[11]Reich, *ante* note 6, at 17; emphasis supplied.

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government who cooperate to identify and solve what they perceive as problems in the productive economy. Some of the plans go further, creating *multipartite boards*, consisting of representatives of business, labor, government, and other special-interest constituencies of the new class, such as academicians, "public-interest" gurus, and financiers. But the basic thrust is more or less identical: Government grants to selected private economic power blocs some measure of legal authority to influence the political decision-making process above and beyond what citizens in general enjoy, or delegates to those blocs an actual share in the authority to enact or enforce laws, rules, and regulations of an admittedly legislative, executive, or administrative character.

The proponents of industrial policy of course also promote more traditional, albeit wide-ranging, schemes for redistribution of wealth. At the expense of taxpayers, they recommend massive new expenditures of the national government to subsidize research and development for favored industries and for industrial education and retraining, unemployment compensation, and health care and disability benefits for employees. At the expense of consumers, the advocates of industrial policy prescribe protection of domestic industries from low-cost, high-quality foreign competition. And at the expense of investors, they demand restrictions on the closure of unprofitable industrial plants in depressed regions of the country. But, in the newest schemes of industrial policy, even these tired redistributionist panaceas appear in distinctly fascistic garb.

Some proposals encourage the extension to employees of the syndicalistic right to participate in undoubtedly managerial decisions, including capital investment, reinvestment, divestiture, and relocation. Other proposals offer the guild-socialistic alternative of governmental subsidies to enable organized employees to purchase and operate plants that investors intend to close because of unprofitability. Still other proposals envision the erection of industrial banks, along the lines of the defunct Reconstruction Finance Corporation, to grant favored industries governmentally guaranteed, low-interest loans or to channel to those industries monies invested by private pension plans in the banks' governmentally guaranteed industrial-redevelopment bonds or other securities. As with the tripartite or multipartite boards, these industrial banks are to consist of representatives of the major power blocs of the new class, especially financiers and bankers, who will direct the future industrial evolution of the country through the grant or denial of governmentally supplied or guaranteed capital.

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For a rather comprehensive example, arguing that "[i]ndustrial policy is an idea whose time is coming in America," a group called the Project on Industrial Policy and Democracy "outline[s] some of the major components of a national industrial policy":

> *A National Investment Bank* . . . would make loans or investments. . . . *A National Planning Board* . . . would develop an overall coordinated plan for the U.S. economy. . . . [T]his planning . . . board would also direct the lending activities of the [re-industrialization] bank.
>
> *Industrial sector and regional committees,* composed of representatives of business, labor[,] government and the public, play a major role. . . .
>
> *Local content legislation* . . .[;] legislation to control *plant closings* and to encourage worker ownership and participation in industry; new *trade laws* to help U.S. firms compete on an equal basis with foreign firms; special aid for basic *research* and *new technologies;* new *education, training, and retraining programs* to make sure that we have the skilled workers that we need. . . .[12]

Specifically advocating syndicalistic "co-determination," the project also supposes that

> [w]orker participation and worker ownership are ideas whose time has come in America. . . . An effective industrial policy will . . . giv[e] priority for contracts and technical and financial assistance to companies which are willing to become more democratic.[13]

And the project candidly admits that its overall goal, a goal not uncommon to proponents of industrial policy, is to "develop an economic plan based on both national and local community needs." Thus,

> [t]he President and Congress should together develop a four year plan for achieving full employment, price stability and real income growth. . . . The plan should be based on the needs of the national economy, but it should also be the result of a bottom-up process of local, community and state planning, by which citizens determine the needs of their communities for jobs, capital investment, training, and industrial development.[14]

A student of 20th-century history might well wonder whether this program for industrial policy originated in the contemporary United States or, perhaps, in fascistic Italy. Certainly a student of constitutional law would immediately question how the government could

[12]Project on Industrial Policy and Democracy, *Our Jobs Our Future: Questions for the Candidates about America's Industry and Economy*, Washington, D.C., 1984, at 4.

[13]Ibid., at 19.

[14]Ibid., at 11.

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plan the entire national economy; that is, how the government could seize from the owners control over the countless decisions as to the industrial uses of private property, without eradicating the very notion of such property from the Constitution altogether. After all, "while property may be regulated [by the government] to a certain extent, if regulation goes too far it will be recognized [by the courts] as a taking."[15] And the encumbrance on industry of presidential and congressional "four year plan[s]," together with an additional "bottom-up process of local, community and state planning," would arguably implicate such pervasive governmental control as to eradicate any semblance of continuing private ownership, other than in a merely titular sense.

Prescriptive and Consultative Proposals for Industrial Policy

Although structurally similar, contemporary proposals for industrial policy do differ in emphasis in a constitutionally consequential manner. One major set of proposals delegates to the multipartite boards an actual prescriptive quasi-governmental authority to promulgate rules and regulations for industry subject only to legislative disapproval or modification, whereas the other major set of proposals establishes the boards as consultative bodies only, with the national government required to hear, but free not to adopt, the boards' recommendations.

In one influential example of a strongly prescriptive industrial policy, the AFL-CIO advocates "a new kind of social contract" among business, labor, and government that would significantly transmogrify American institutions.[16] Congress, the AFL-CIO demands, must create a

> tripartite National Industrial Policy Board (NIPB) with representatives of labor, business and the government. . . .
>
> Established by congressional mandate and delegation of authority, the [NIPB] would . . . strengthen both emerging and established industries through . . . an industrial development bank [similar to the Reconstruction Finance Corporation (RFC) of the 1930s and 1940s] which would make and guarantee loans to finance approved reindustrialization projects . . . targeting special assistance to promote industry and regional development goals . . .[, and] undertaking broad-ranging analyses and developing specific recommendations toward further changes in law and policy. . . .
>
> Industry and area reindustrialization proposals would be developed by individual tripartite committees, based on their members'

[15]Pennsylvania Coal Co. v. Mahon, 260 U.S. 393, 415 (1922).

[16]"Rebuilding America: A National Industrial Policy," *The AFL-CIO American Federationist* 90 (22 October 1983): 1.

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> thorough knowledge of circumstances in each region and industrial sector. . . .
> . . . Forwarded to the Congress for in-depth dialogue with appropriate committees, the [NIPB's] development plan would stand, subject to full congressional action. . . .
> The criteria applied by the NIPB in evaluating proposed industry or area plans or loan proposals should go beyond the limited balance sheet of private profitability. . . .[17]

Several aspects of the AFL-CIO's proposal for an industrial policy are noteworthy. First, the tripartite national and regional boards would enjoy a "delegation of authority" from Congress—that is, a "mandate" to function as quasi-legislative bodies. Yet the boards would consist primarily of business and labor representatives from *private* economic power blocs, representatives no doubt carefully selected to promote the interests of businessmen and union leaders favorable to the anti-market goals of the new class.

Second, reflecting its "delegation of authority" and quasi-autonomy, the national tripartite board's "development plan [will] stand, subject to full congressional action." Thus whatever deal or arrangement the representatives of business and labor concoct with the governmental members of the board would automatically have the force of law or administrative regulation, unless Congress specifically overrides it by statute.

Third, the board would not be limited by such rational market criteria as profitability, but could "attun[e]" itself to "the long-term development and welfare of the nation" without regard to, and measured by some standard other than, profit.

Fourth, the board would withhold funds or other aid from companies that refused to engage in whatever the board deemed "productive" and "responsible" actions (presumably without regard to profit), thereby enabling the board to exercise pervasive socioeconomic direction and control over the recipients of its largesse. A not surprising example of what the AFL-CIO considers "responsible" corporate behavior is its recommendation that employers "acknowledge the rights of workers to join together in democratic labor unions and refrain from campaigns to destroy unions." Under the present national labor laws, of course, employers must already "acknowledge" the rights of their employees to form and join, *or not to form and join,* labor unions.[18] What the AFL-CIO demands is that employers *affirmatively promote* unionization, in direct contradiction of the statutory

[17]Ibid., at 3–4.

[18]National Labor Relations Act § 7, 29 U.S.C. § 157.

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policy of employer neutrality that the labor laws now mandate,[19] and in derogation of employees' constitutional freedom of nonassociation underlying that policy.

Fifth and last, by selling its governmentally guaranteed obligations to employee pension funds, the new RFC could divert the funds' immense financial resources from market to non- or anti-market uses, later reimbursing the funds' beneficiaries for any losses through taxation or increases in the supply of Federal Reserve System fiat currency.[20]

A prime example of a consultative industrial policy is the proposed Industrial Competitiveness Act, introduced by Representative John J. LaFalce.[21] Although not entirely unwelcomed by organized labor,[22] the Industrial Competitiveness Act avoids direct delegation of quasi-legislative authority to the multipartite board it creates, giving some force to the quotation by LaFalce of Lester Thurow's denial that such a purely advisory board is fascistic:

> Technically, corporativism exists when public powers are delegated to private decision makers. . . .
>
> In this sense, industrial policies are not corporativism. For all public decision-making powers will remain with the democratically elected officials who now make them and all private decision-making powers will rest with the private decision makers who now make them. Neither side can force the other to make decisions that they do not want to make. As a result, industrial policies are neither centralized government planning nor private corporativism.
>
> With industrial policies, private and public decision makers get together to see if they can exchange information and coordinate actions so that each makes better decisions than if their decisions are made in isolation.[23]

Specifically, the Industrial Competitiveness Act establishes a Council on Industrial Competitiveness as an "independent agency" in the executive branch of the national government,[24] with the duties

[19]National Labor Relations Act § 8(a)(3), 29 U.S.C. § 158(a)(3).

[20]Not accidentally in the context of its explicitly anti-market proposals, the AFL-CIO decries "restrictive monetary policies." "Rebuilding America: A National Industrial Policy," *ante* note 15, at 3.

[21]H.R. 4360, 98th Cong., 2d Sess. Similar bills include H.R. 5827, 98th Cong., 2d Sess. and H.R. 5828, 98th Cong., 2d Sess.

[22]AFL-CIO member International Association of Machinists (IAM) concedes that "H.R. 4360 isn't all the IAM has proposed . . . , but it has enough of those features to make it a good bill to start with." "An Open Letter to Congress: Dear Representative. . . ," *The Machinist* 39 (May 1984): 2.

[23]Thurow, "The Case for Industrial Policies," quoted in *Congressional Record* (17 May 1984), at E2254.

[24]H.R. 4360, 98th Cong., 2d Sess., § 101.

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inter alia to "collect and analyze . . . data"; "monitor the changing nature of the United States industrial economy"; "prepare and publish reports containing the recommendations of the Council with respect to industrial development priorities"; "create a forum . . . where national leaders . . . will . . . identify national economic problems . . . [,] develop recommendations to address such problems . . . [, and] create a broad consensus in support of such recommendations"; "establish industry subcouncils . . . to develop similar long-term strategies for sectors of the economy"; "provide policy recommendations and guidance to the Congress, the President, and the Federal departments and agencies"; "provide guidance and recommend lending priorities for the Bank for Industrial Competitiveness [created by the act]"; and "stimulate and promote employee ownership" of industrial firms.[25]

The council consists of sixteen members, appointed by the president with the advice and consent of the Senate and removable only for malfeasance in office. Four of them "shall be heads of Federal departments or agencies, Members of Congress, or representatives of State or local governments"; four of them "shall be national leaders with experience and background in business"; four of them "shall be national leaders with experience and background in the labor community"; and four of them "shall be selected from the academic community or have been active in public interest activities".[26]

In fulfillment of its statutory duties, the council may hold hearings, take testimony, and receive evidence; secure necessary information "directly from any department or agency of the United States"; establish "industry subcouncils of public and private leaders representing the major economic interests affected by sectoral policies"; "continuously monitor . . . the effect of imports on all major United States industries"; "annually prepare and transmit to the President, to each House of the Congress, and to the Bank for Industrial Competitiveness a report setting forth . . . the major industrial development priorities of the United States . . . [,] the policies needed to meet such priorities . . . [,] a summary of existing Government policies affecting industries . . . [, and] any recommendations of the Council for . . . legislative or administrative actions, or actions by the Bank for Industrial Competitiveness"; and "consult" with appropriate committees of both Houses of Congress, whereupon "each such committee shall submit to its respective House a report setting forth the views and

[25]Ibid., § 102.
[26]Ibid., § 103.

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recommendations of such committee with respect to the report of the Council".[27]

Although the act does not directly delegate quasi-legislative authority to the council, it does provide selected representatives of the new class with an officially sanctioned—and, from a merely practical perspective, politically powerful—platform from which to propagandize the country, and particularly the president and the Congress, on the "national economic problems" the new class imagines exist and the "solutions" to those problems that it deems necessary. Indeed, the act explicitly defines the purpose of the council as being to set up "a forum or forums" in which the representatives of the business and labor elites, together with sympathetic politicians and academicians, will actually "*create* a broad consensus in support of [their] recommendations." And the very nature of the act indicates that this "consensus" will be anything but market-oriented. After all, no group in society has a stronger interest in the efficiency of American industry than consumers. Yet the act nominates no consumer representatives to the council, except insofar as members with so-called public-interest backgrounds may adventitiously have personal pro-consumer attitudes. Moreover, although the vast majority of employees in American industry are not members of unions, the act's jargonistic reference to the "labor community" suggests that the "labor" spokesmen will likely represent *organized* labor only.[28] In short, the act is designed precisely to give official force and practical weight to one side in the political debate on governmental regulation of industry, by appointing the spokesmen of that side as "public" officials impressed with the authority to use the resources of the national government to influence Congress to enact interventionistic legislation.

Thus, although not as blatant as the AFL-CIO's proposal, the act nevertheless embodies in important degree the distinctly fascistic formal organization of political influence according to representation by interest group or class—and then limits that representation to certain politically select classes. Under the concept of freedom of petition in the First Amendment to the Constitution, however, all individuals and voluntary groups have *legal equality of opportunity* to request governmental action on their behalf; but no individual or

[27]Ibid., §§ 105–7.

[28]Other bills implementing industrial policy are more candid: For example, H.R. 5827, 98th Cong., 2d Sess., § 5(a)(2)(B)(i) (two members of proposed "National Industrial Revitalization Board" must be, "on the date of their appointment, officials of national or international labor unions"); H.R. 5828, 98th Cong., 2d Sess., § 5(a)(1)(c) (four members of proposed "National Commission on Industrial Policy" must be "officials of national or international labor unions").

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group is legally entitled to discriminatory governmental aid in promoting his or its interests in the political arena.[29] So even the merely consultative nature of the multipartite board in this proposal raises a serious constitutional problem.

The Industrial Competitiveness Act also establishes a "Bank for Industrial Competitiveness." The bank consists of twelve directors, one from each of the categories of members of the council, and eight appointed by the president with the advice and consent of the Senate from among "individuals who have substantial experience and expertise in the fields of business investment, industrial development, or public or private finance."[30] The act empowers the bank to extend financial assistance for industrial "revitalization," by making loans, guaranteeing loans, and purchasing capital stock of applicants for its aid. However, the bank may provide such assistance only if the applicant "submits a written request . . . accompanied by a plan which, in the judgment of the Bank . . . explains the need for such assistance" and inter alia "includes details concerning . . . production, distribution, and sales plans." Moreover, the bank may grant "[n]o assistance . . . for projects whose primary purpose is to facilitate or impede the relocation of industrial or commercial plants from one area to another."[31] On similar terms, the bank may provide financial assistance for industrial "innovation."[32]

The act further authorizes the bank to guarantee loans "backed by the full faith and credit of the United States," and to issue its own bonds "guarantee[d] . . . with the full faith and credit of the United States."[33] In addition, "the bank shall endeavor, to the maximum extent possible . . . to guarantee loans from [private] pension funds to industry," and "to sell [its] bonds . . . to [private] pension funds."[34]

Distinguishably from the council, then, the bank has explicit power itself to intervene in the national economy through its highly selective financial operations, and to direct or control the recipients of its aid in an essentially unlimited manner.[35] The bank thus amounts to

[29]See E. Vieira, Jr., *"To Break and Control the Violence of Faction": The Challenge to Representative Government form Compulsory Public-Sector Collective Bargaining* (Arlington, Va.: Foundation for the Advancement of the Public Trust, 1980), at 49–50.

[30]H.R. 4360, 98th Cong., 2d Sess., § 202.

[31]Ibid., § 205.

[32]Ibid., § 206.

[33]Ibid., §§ 207(f)(1) and 208 (1)(2)(A).

[34]Ibid., §§ 207(f)(2) and 208(1)(3).

[35]The act broadly licenses the bank to "establish, from time to time, such additional standards and conditions for eligibility for financial assistance . . . as the [bank] deems appropriate." Ibid., § 205(e).

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a massive "slush fund," underwritten by "the full faith and credit of the United States," with which representatives of the new class may promote and manipulate the industries they identify as needing "revitalization" or promising "innovation," according to whatever economic, social, political, or ideological criteria those representatives deign to employ. Moreover, the act implicitly contemplates that the financial assistance it authorizes will amount to subsidization, rather than prudent investment (in the traditional market sense); for otherwise it would be unnecessary for the bank to guarantee loans from private pension funds to selected industries, or to sell those funds the bank's own, governmentally guaranteed bonds.[36] To be sure, the act mandates that there be "reasonable assurance of repayment of any loan or loan guarantee" the bank extends.[37] But what is "reasonable"to the bank obviously need not correspond to a *market* rate, expectancy, or security of return on a loan; for if the market would float the loan, the bank's financial intervention would be unnecessary.

Revealingly, too, the act explicitly disables the bank from promoting market forces as far as geographical transfers of capital are involved, by outlawing assistance "for projects whose primary purpose is to facilitate or impede the relocation of . . . plants from one area to another."[38] In as much as private projects designed to "impede . . . relocation" of the recipients' own plants are difficult to imagine, this provision evidently reduces to an attempt to stifle interstate industrial commerce, arguably in contravention of the Commerce Clause of the Constitution.[39]

The Political-Economic Motivations Behind Demands for Industrial Policy

The manifestly anti-market and elitist attitudes of proponents of industrial policy, and the strongly fascistic character of what they propose, expose their practical political-economic motivations. The special-interest groups that constitute the new class—businessmen

[36]Pension fund fiduciaries who risked the funds' monies on the type of "revitalization" and "innovation" loans the act contemplates would be engaging in so-called social investing, which is now illegal under the Employee Retirement Income Security Act. See Vieira, " 'Social Investing': Its Character, Causes, Consequences, and Legality under the Employee Retirement Income Security Act of 1974," A study prepared for the Labor Management Services Administration, U. S. Department of Labor, February 1983.

[37]H.R. 4360, 98th Cong., 2d Sess., §§ 205(d)(4), 206(d)(4).

[38]Ibid., §§ 205(h)(2), 206(h)(2).

[39]U.S. Const., art. I, § 8, cl. 3.

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greedy for governmental protection and subsidization; officials of organized labor intent on safeguarding the gains of restrictionistic unionism against the corroding effects of competitive domestic and international labor markets; politicians and bureaucrats eager to secure electoral support and to expand their fiefdoms of power; academicians and "public-interest" gurus hostile to the market and committed to its replacement by "planning" agencies through which they can enforce their own ideas of the "social good" on the reluctant masses—do not need such special mechanisms as multipartite boards to attempt to influence the national government in ways favorable to the substantive goals of industrial policy. All special-interest groups, including the constituents of the new class, already can participate with formal equality of legal opportunity in partisan politics, lobbying, propaganda and agitation, political litigation, and the organization of political coalitions to promote their pet projects. To the new class, however, the formal equality of legal opportunity to petition government traditional in the United States is not enough. For, under these circumstances, the power blocs of the new class have demonstrably failed to arrange for legislation installing the complex of interventions necessary for the coherent industrial policy favorable to their interests.

Formal equality of legal opportunity to petition government has led, in the event, to actual inequality of practical effect—simply because other groups, exercising their own legal privileges to petition the government, have bested, or at least thwarted, the new class in political maneuvering. In recent years, even the dullest segments of the community have begun to realize that much deceptively mislabeled "public-interest" legislation is in reality the means for special-interest-group predation of society. Old apologies for interference with the market have increasingly been debunked, not only in academic circles but even in the mass media. And the opponents of interventionism have effectively organized themselves, through political action committees and other devices, to win electoral contests and lobbying battles. To forestall further defeats in the arena of democratic politics, the new class now proposes, under the guise of industrial policy, simply to circumvent democracy to the maximum degree possible—either through prescriptive multipartite boards, which themselves will exercise quasi-governmental power; or through consultative multipartite boards, which will enjoy special access to, and influence over, elected and appointed legislative, executive, and administrative officials. At base, industrial policy seeks to replace the constitutional principle of formal equality of legal opportunity for all individuals and groups to petition government with the

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fascistic principle of formal inequality of political privileges for the special benefit of elite economic and social power blocs.

The immediate goals of the new class are self-evident. First, industrial policy seeks to reduce public visibility of the new class's influence on the national government or (insofar as its visibility cannot be obscured) to give that influence the veneer of "official" respectability by channeling it through a multipartite board nominated by the president and confirmed by the Senate.[40] Second, industrial policy seeks to preempt the formation of politically powerful antagonists of the new class by permanently ensconcing its representatives as the only members of the new multipartite board empowered to direct the course of political discussion on economic intervention, even to "creat[ing] a broad consensus in support of [its] recommendations" throughout government and elsewhere. Third, industrial policy seeks to enable the new class to stop, or at least to retard, the eroding effect of market forces on the economic bastions of monopoly and restrictionism, particularly in aid of the labor unions comprising the AFL-CIO. Fourth, industrial policy seeks to reward anti-market actions by business and labor, or at least to render them less costly, thereby creating a system of governmentally subsidized anti-market incentives in an attempt to counteract the market's otherwise relentless punishment of producers that fail to serve the consumers diligently. Fifth, industrial policy seeks to plunder private labor-management pension funds by diverting their assets to anti- or non-market uses, thereby compelling the market to finance its own destruction.[41] And sixth, industrial policy seeks to erect a governmentally sponsored platform for incessant anti-market propaganda, in the hope of intellectually and politically legitimizing once again, by filtration through the new layer of bureaucratic mumbo jumbo the multipartite board will excogitate, the shopworn precepts of interventionism that America has already examined, found wanting, and begun decisively to repudiate at the polls.

The long-term goals of the new class are also readily apparent. First, industrial policy will provide a training ground for generations of fascistic "planners" and an experimental laboratory for their "plans,"

[40]A not unlikely model here, of course, is the Federal Reserve System, which the great majority of Americans misperceives as a purely governmental agency when, in reality, it is a largely private, corporative-state banking cartel. See E. Vieira, Jr., *Pieces of Eight: The Monetary Powers and Disabilities of the United States Constitution* (Old Greenwich, Conn.: Devin-Adair, 1983), at 346–55.

[41]This aspect of industrial policy already has a separate existence, albeit approximately the same constituency, under the label "social investing." See Vieira, *ante* note 36.

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involuntarily subsidized by the victims of those plans through taxation or monetary expansion. And second, industrial policy will provide a foundation, or "first step," for more ambitious programs designed, not simply to revitalize declining American industries or to stimulate innovation, but instead to manipulate the entire productive economy in accordance with the new class's social agenda.

A Political-Economic Critique of Industrial Policy Proposals

That contemporary proposals for industrial policy complexly admix economic and political elements complicates constitutional analysis, because the Supreme Court's principles for reviewing the legality of legislative enactments differ radically depending on whether the legislation *sub judice* is predominantly "economic" or "political" in nature (as the Court understands the latter terms). For this reason careful consideration of both the economic and political ramifications of industrial policy is appropriate.

The Absence of a Sound Economic Basis Subtending Industrial Policy Proposals

According to the Supreme Court's present view, Congress may enact any legislation in the economic area that has a so-called rational basis: "[R]egulatory legislation affecting ordinary commercial transactions is not to be pronounced unconstitutional unless in the light of facts made known or generally assumed it is of such a character as to preclude the assumption that it rests on some rational basis within the knowledge and experience of the legislators."[42] And typically, supposed "market failures" provide the context for such legislation: "[R]egulation is within [the government's] power whenever any combination of circumstances seriously curtails the regulative forces of competition, so that buyers and sellers are placed at such a disadvantage . . . that [the] legislature might reasonably anticipate serious consequences to the community as a whole."[43] Of course, the court's rational-basis test lacks constitutional cogency in many respects.[44] But, at the very least, it does require those supporting a

[42]United States v. Carolene Products Co., 304 U.S. 144, 152 (1938).

[43]Ribnik v. McBride, 277 U.S. 350, 360 (1928) (Stone, J., dissenting). The essence of Justice Stone's dissent in Ribnik was later adopted as majority doctrine by the Court in such cases as Ferguson v. Skrupa, 372 U.S. 726 (1963), and Williamson v. Lee Optical Co., 348 U.S. 483 (1955).

[44]See Vieira, *ante* note 3, at 1480–94; Gulf, C. & S. F. Ry. v. Ellis, 165 U.S. 150, 154 (1897); West Coast Hotel Co. v. Parrish, 300 U.S. 379, 401–02 (1937) (Sutherland, J., dissenting).

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piece of economic legislation to present a prima facie defense of the enactment's real and substantial relation in reason to a legitimate public purpose.[45] And this, even a cursory analysis indicates, the proponents of industrial policy would be hard-pressed to do.

Even if its advocates honestly, albeit naively, believe that industrial policy can somehow perfect market mechanisms (or at a minimum mitigate market failures), and therefore aim at a public purpose legitimate under the Commerce Clause of the Constitution,[46] their proposals nevertheless lack a real and substantial rational relation to that goal. For industrial policy by and large addresses economic problems caused by, or arising out of, the incoherence and perniciousness of already existing governmental intervention, not imperfections or failures of the market.[47]

The fundamental difficulty with industrial policy traces to the faulty contemporary political-economic teaching of welfare-state advocates that government can and should reduce the economic and social instability and insecurity attendant on market change, while at the same time promoting (if not actually guaranteeing) a continual rise in living standards. Inherent in this notion is the inescapable contradiction that increases in living standards necessarily imply constant economic change, in terms of new technologies, products, services, and markets, and that economic progress of this kind inexorably imposes instability and insecurity on those whose incomes and social positions derive from or depend upon old technologies, products, services, and markets. The welfare state's prescription for intervention is thus schizophrenic: On the one hand it demands that government attenuate the inevitable effects of all economic change; and on the other hand it demands that government accelerate at least some of the major changes that produce these effects. Obviously, then, the rationality of an industrial policy that aims at simultaneously revitalizing segments of industry that market changes are causing to contract, and promoting innovation in other segments from which the market withholds capital because the alleged innovations are economically unsound, is open to serious question.

Similarly, the oft-articulated criticism by exponents of industrial policy that the profitability of many modern industries relates less to

[45]Compare Railroad Retirement Board v. Alton R. R., 295 U.S. 330, 347–48 n.5 (1935), and Nebbia v. New York, 291 U.S. 502, 525 (1934), with Mayflower Farms, Inc. v. Ten Eyck, 297 U.S. 266, 274 (1936).

[46]U.S. Const., art. I, § 8, cl. 3.

[47]If, on the other hand, the true purpose of industrial policy were selectively to enforce protectionism on behalf of politically influential industries or regions, its constitutional illegitimacy would be nakedly apparent.

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successful competition in the market place than to skillful maneuvering in the political arena, and that therefore increased political intervention through multipartite boards and other devices is justifiable, also fails the test of rationality. The national government's policies regarding taxation, spending, and regulation, together with the entire present-day system of political favoritism that pervades Washington, D.C., create numerous incentives and disincentives to which business, organized labor, and other special-interest groups have favorably adapted, usually at the expense of society as a whole. For that reason, exponents of industrial policy are descriptively correct in noting that distinctions between governmental and market activity have increasingly blurred in recent years. They are not, however, analytically or prescriptively correct in attributing this state of affairs to a failure of the market, or in promoting further governmental intervention to palliate the effects of earlier political errors. To the contrary: If contemporary political entrepreneurship is a problem precisely because of governmental overinvolvement in the economy, and if some new governmental agency (or semi-private multipartite board or bank) with enlarged authority to commandeer part of the nation's capital to aid some industries and regions at the expense of others would likely become the immediate target, and perhaps captive, of special-interest-group politicking, then industrial policy as now formulated is manifestly counterproductive. Self-evidently, if a legitimate public purpose behind industrial policy were to depoliticize the economy in favor of efficiency, the creation of some new quasi-governmental entity with the at-least-implicit mandate of directing capital into non- or anti-market uses in order to serve various parochial political constituencies would lack a real and substantial relation in reason to that purpose.

Their critics should not lightly assume the good faith of proponents of industrial policy, however. Revealingly, although they evince supposed concern for mitigating market failures, advocates of industrial policy reject numerous market solutions to contemporary economic problems, such as monetary reform, to return the country to the silver- and gold-based standard that both the Constitution and sound economic policy require; labor-law reform, to eradicate the noxious principles of exclusive representation and compulsory collective bargaining that enable unions to exercise restrictionistic powers over the labor market; tax reform, in the direction of a flat-rate or other tax less damaging to capital formation and economic incentives than the present graduated income tax; and educational reform, to break the stranglehold of the public schools (and such public school unions as the National Education Association) over intellectual development

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of the nation's youth. And their argument that the free market is, in any event, largely a myth belies any real concern on their part for the market—or its corollary, economic freedom.

This, of course, raises a serious analytical problem, in that constitutional regulation through economic legislation presupposes the existence of two separate spheres of activity, private and public: (i) the market, in which individuals and voluntary groups autonomously order their interrelations through the legal principles of property and contract, and (ii) the political process, through which decisions are reached, and coercively enforced, on issues irresolvable by application of the latter principles.[48] If the free market is a myth, though, then so ex necessitate are its major legal attributes, property and contract; such constitutional precepts as that "[n]o person shall . . . be deprived of . . . liberty, or property, without due process of law; nor shall private property be taken for public use without just compensation"[49] become meaningless; and government has totalitarian authority. Obviously, if one major purpose of the Constitution—therefore, a compelling duty of government—is to protect individuals' liberty and property, then an industrial policy that for all practical purposes presupposes the nonexistence of those legal categories cannot be rationally related to a legitimate governmental end.

Conversely, even if one assumes arguendo that the proponents of industrial policy honestly intend it to enhance the operation of the market, in the sense of having significantly positive effects on the development and implementation of business strategies without coercive bureaucratic planning, industrial policy nevertheless stumbles at the threshhold of economic rationality because the intention is incapable of implementation. This is true for the following five reasons.

First, the proponents of industrial policy simply disregard the paradoxical constraint that the information critically necessary to any economically rational industrial policy is available only through the operation of the unfettered market itself. For that reason, insofar as industrial policy truly attempts to enhance the market through the use of market-derived information only, it is supererogatory; and insofar as industrial policy attempts to change the market "for the better" through the use of nonmarket (that is, overtly political)

[48]In constitutional terms, commerce (or economic activity) is not and cannot be politics (or governmental activity). See National League of Cities v. Usery, 426 U.S. 833 (1976), and especially the penetrating brief *amicus curiae* filed therein by Professor Sylvester Petro on behalf of the Public Service Research Council.

[49]U.S. Const., amend. V.

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information, or by selectively disregarding market-derived information (according to political criteria of choice), it amounts to a form of coercive central planning inconsistent with liberty and property. In short, if industrial policy were economically rational, it would be unnecessary; and if it were economically nonrational, it would therefore be arguably unconstitutional on that ground alone.

Moreover, on the purely practical level of information retrieval, industrial policy faces numerous problems. For an industrial policy based on the dissemination of information to be successful, some agency must gather data that the business managers who make key strategic decisions in the market can and will actually trust and use, because those data accurately and objectively derive from and reflect the market rather than constituting propaganda tailored to serve the parochial economic ends of narrow special-interest groups, or mis- or dis-information designed to advance some group's non- or anti-market political and ideological goals. Yet no substantial evidence in the literature favorable to industrial policy demonstrates that the government, or some quasi-governmental multipartite board, *can* develop real, *market-based* information that is not already available to managers of business, labor leaders, academicians, or others. In the first place, a great deal of the most important information about business opportunities and strategies is proprietary in nature and therefore immune from discovery by any noncoercive governmental agency. Furthermore, much of the available information most crucial to managerial decision making travels through highly specialized, informal, and often exclusive networks of personal contacts that outsiders do not have access to or the expertise to evaluate. In other cases, typical major corporations and unions already devote sizeable resources to gathering, sifting, analyzing, evaluating, testing, and circulating information—leaving little for a new governmental agency to contribute. Indeed, what passes for information in encomia of industrial policy is in most instances pure hindsight. And certainly no governmental agency can provide information about the intrinsically unknowable future events on which entrepreneurs must speculate in the market.

In sum, information that can aid market processes is only partly public, necessarily complex, highly specialized, and largely judgmental in character. On the one hand, if a governmental board solicited private companies and unions to provide the raw data for industrial policy, it would simply invite the presentation of self-serving propaganda and the withholding of what the respondents considered strategically important to themselves. Thus, the government's information would amount merely to commonly available data, perhaps

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purposefully doctored at the sources, the accuracy of which its recipients would strongly tend to doubt and discount ab initio. On the other hand, if a governmental board developed its supposed data from non-market sources, the resulting information, by hypothesis, would be largely political in nature—along the lines of the empty exhortation "This course of action is in the public interest!" Thus, the government's information would amount merely to ideological propaganda, which intelligent businessmen would obviously disregard completely.

Second, the structure of incentives the advocates of industrial policy propose to create is nonrational in the context of a market economy. In general, the proponents of industrial policy argue that groups suffering the detriments of economic change should receive compensation from the beneficiaries of that change. Specifically, to prevent an uneconomic plant from closing, they say, the government should subsidize its operation; or, if closure is unavoidable, the government should retrain, relocate, or otherwise aid displaced employees. Economic guarantees of this sort, however, will merely encourage businessmen to ignore production costs and union leaders to demand exorbitant wage rates, in the anticipation that the government will coerce other innocent groups to share in the economic risks of such irresponsible behavior. Thus, industrial policy of this kind will simply reward failure, waste, and greed by externalizing their costs, in effect establishing a pernicious system of redistribution of wealth based on economic *dis*service to the community.

Third, the very argument that certain types of industrial revitalization and innovation need governmental coercion to obtain sufficient financial backing evidences the inefficiency that industrial policy will predictably promote. For example, in the type of industrial bank to be established under the Industrial Competitiveness Act, loans and loan guarantees will be made, not by market entrepreneurs risking their own capital, but by political appointees playing with the taxpayers' monies. Under the terms of that act, any loan or loan guarantee must show a "reasonable assurance of repayment." But what the bank considers reasonable will doubtlessly turn on political, not market, criteria. After all, borrowers will need the bank's services only to the extent that the market considers them credit risks or foresees that their projects will be unprofitable. Thus, by hypothesis the bank will divert capital from productive to relatively unproductive employments; and its investments will therefore necessarily be *unsound,* according to any rational market criteria, in comparison to the competing investments the market would have made in the absence of the bank's intervention. Moreover, the diversion of

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capital—especially the hundreds of billions of dollars in private pension fund accounts—from market investments directed by the demands of consumers to industrial bank investments directed by the commands of multipartite boards representing narrow special-interest groups and intellectuals antagonistic to the market will convert the American economy pro rata to a planned system of production, with all the deleterious consequences for rational economic calculation that that change entails.

Fourth, a fundamental premise of contemporary industrial policy is that various groups in society—in particular, unionized wage earners—have "economic rights" that the government must protect against erosive market change by forcing other groups—such as employers, shareholders, pension fund beneficiaries, or taxpayers—to subsidize those wage earners' continued employment, income, or other benefits. For example, numerous proposals for industrial policy embody restrictions on the mobility of productive capital, through limitations on the closure of uneconomic plants or on the transfer of capital assets from one region of the country to another. At base, the doctrine of economic rights implicit in industrial policy rests on the Marxian notion that the interests of employees inexorably and irreconcilably conflict with the interests of employers (or investors), and adopts the welfare state prescription of politicization of the relationship between employees and employers in favor of the former and at the expense of the latter.[50] However, besides being morally reprehensible,[51] this class-conflict thesis is economically incoherent, there being an intense and mutually beneficial community of interests between employees and employers in the market system of production. How the market process of cooperative effort among productive groups can be improved by imposing on it programs derived from the nonrational, anti-market mythology of inescapable, fatal antagonism among those groups, the advocates of industrial policy do not explain.

Fifth and last, of little value are the promises of some proponents of industrial policy that the multipartite boards and banks they advocate will not engage in coercive quasi-governmental planning, at the expense of market rationality. An underlying assumption of the multipartite-board strategy is that such a forum will facilitate understanding and generate consensus on socially acceptable and economically effective measures to advance American industry. This further assumes

[50]As used herein the term "welfare state" imports a corporativistic democracy in which unions and their intellectual allies exercise political dominance.

[51]See Encyclical Letter of Pope John Paul II, "On Human Work" ("Laborem Exercens"), pt. IV, § 20.

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the existence of barriers to effective communication and cooperation among the major parties to key economic decisions—barriers governmentally sponsored discussions among selected representatives of some businesses, organized labor, academia, "public interest" groups, and the financial elite supposedly can overcome. Yet no one has made clear why the mere governmental sponsorship of such discussions among an elite coterie of politically influential individuals will encourage agreement on issues that the great mass of economic actors in the market presumably already knows divide them, and already has every economic incentive to resolve. High-level governmental groups organized to coordinate economic policy are not novel in this country, after all. Under President Nixon, there was the Council on International Economic Policy; under President Ford, the Economic Planning Board; and under President Carter, the Economic Planning Group. None of these, however, was effective—or, at least, as effective as the advocates of industrial policy say is necessary or possible. Why? No doubt because each of them lacked the political authority to coordinate its policies effectively, through governmental *coercion* as well as rhetoric.

If the government is "weak," then, in the sense that it lacks the political authority or will to impose a truly stringent program on reluctant employers or unions, industrial policy will probably amount to little more than a device through which pliant politicians and greedy businessmen and union leaders conspire to advance their short-term institutional interests—most likely through one or another form of protectionism. Conversely, if the government is "strong," in the sense that it seizes the political initiative to enforce consensus among even strenuously objecting employers and unions, industrial policy could achieve major changes in the direction of the American economy—but only towards non- or anti-market goals. Thus, if industrial policy is more or less rational, in that it merely serves as a forum for the exchange of economic data that participants in the market are free to accept or reject, it will be ineffective from the perspective of its advocates. And if it is effective from their perspective, industrial policy will be economically nonrational, because it will substitute for the voluntary decisions of market participants the imposed decisions of politicians, *fonctionnaires,* or quasi-bureaucratic representatives of the new class.

The Presence of Serious Political Objections to Industrial Policy

Even if contemporary proposals for industrial policy were to suffer less than they do from economic nonrationality, they would

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nevertheless be seriously objectionable on political grounds. This is of great constitutional consequence, in as much as the Supreme Court regularly accords far greater protection to individual rights it considers "political" than to rights it can dismiss as merely "economic."[52] Even the most cursory analysis demonstrates that, as their own advocates structure them, the mechanisms for formulating industrial policy are inconsistent with the traditional American system of constitutional checks and balances and inimical to political equality among all citizens.

All major proposals for industrial policy advocate creation of an independent multipartite board located within the executive branch of the national government and possessed of either prescriptive or consultative authority vis-à-vis not only other administrative agencies but Congress as well. However, if such a board is to exercise true independence, and avoid functioning merely as an arena in which special-interest groups maneuver in mere preparation for lobbying Congress itself to take the decisive steps involved in implementing industrial policy, then the board must be largely immune from routine congressional oversight of and intervention in its operations. That is, for industrial policy to function in the dynamic and coherent fashion its exponents envision, Congress must effectively suspend its routine legislative authority over the economic issues that policy involves and more or less delegate broad discretion and freedom of action to the members of the multipartite board. Indeed, explicit in the AFL-CIO's version of industrial policy is the requirement that the decisions of the board automatically have the force of law *unless Congress affirmatively overrides them.*[53]

None of today's important proposals for industrial policy specifically empowers the president to direct, or even directly to participate in, the policymaking process, except initially by appointing the members of the multipartite board. But the authors of these proposals will doubtlessly soon realize that the appearance of democratic legitimacy for their creations demands such a role for the president, as the one coordinate branch of the national government elected by all the people of the United States. A restructuring of the multipartite boards to bring them under the immediate control of the president, however, would not obviate the problem of constitutional checks and balances inherent in industrial policy. For, by constitutional hypothesis, the president is a *coordinate* branch of the national government, *co-equal*

[52]See the seminal statement of this dichotomy in United States v. Carolene Products Co., 304 U.S. 144, 152 n.4 (1938).

[53]See *ante*, note 17 and accompanying text.

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to Congress and to a great degree independent of control by that body.[54] So, under such an amended proposal, Congress would delegate to another branch of the national government powers the Constitution explicitly grants to it alone, under circumstances in which it could not control the exercise of those powers without actually rescinding its delegation of them.[55]

Conversely, under the more blatantly elitist proposals for industrial policy currently extant, a different (but no less egregious) problem of checks and balances exists. For, whatever the strict independence of the multipartite board, that board must exercise *some* quasi-governmental power, or enjoy *some* unique privilege to influence Congress or other arms of the national government, if its existence is to have any practical meaning whatsoever. And whatever its powers or privileges, that board overwhelmingly consists of individuals who, although perhaps capable of being labeled "public officials" because of the mechanism of their appointments, nevertheless remain private parties in contemplation of law, precisely because they are selected on the basis of their connection with, and for the explicit purpose of representing, the major private subgroups of the new class.

The theoretical possibility of legal challenges to the misuse of the multipartite board's powers or privileges, or to the president as leader of or participant in the operations of such a board, provides no realistic means to mitigate constitutional problems through judicial oversight of the day-to-day operations of the board, either, for three reasons. (i) The courts will likely shun any involvement in the complex of economic-cum-political issues by denying litigants standing to prosecute civil actions.[56] (ii) The courts will be particularly chary of interfering in the exercise of presidential authority.[57] And (iii) at most the courts will fashion but a grudging remedy applicable only to egregiously lawless conduct.[58]

[54]See Town of South Ottawa v. Perkins, 94 U.S. 260, 268 (1876) (defining "coordinate" branch of government as "one [that] has no power to enforce its decision upon the other ['coordinate' branch]").

[55]Of course, such an attempted unfettered delegation of legislative authority to the executive branch would be unconstitutional. A. L. A. Schechter Poultry Corp. v. United States, 295 U.S. 495, 529–42 (1935).

[56]For a similar result in the case of the analogous Federal Reserve System, see Raichle v. Federal Reserve Bank of New York, 34 F.2d 910 (2d Cir. 1929).

[57]See, for example, Mississippi v. Johnson, 71 U.S. (4 Wall.), 475, 498–99, 501 (1866); Perkins v. Lukens Steel Co., 310 U.S. 113, 127–28 (1940).

[58]For example, something akin to the so-called duty of fair representation in labor law, which protects employees against improper representation by unions only when the unions' conduct is palpably "arbitrary," "malicious," or "in bad faith." See Steele v. Louisville & Nashville Railroad Co., 323 U.S. 192 (1944).

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In sum, contemporary proposals for industrial policy raise serious checks-and-balances issues in that, insofar as they are effective, they withdraw from Congress some portion of its constitutional authority.

Contemporary proposals for industrial policy also threaten seriously to infringe on political equality for the peculiar benefit of the new class. Advocates of industrial policy argue that implementation of such a policy is necessary to overcome, through democratic discussion and action, the economic and social shortsightedness of entrepreneurs whose lust for profits causes them to ignore the human effects of plant closures, unemployment, the loss of welfare services through shrinking tax bases, and so on. That industrial policy might be democratic is, however, constitutionally irrelevant. For the Constitution sanctions no doctrine of unlimited majority rule, whatever the composition of the majority. Rather, it conditions the exercise of all governmental authority on the recognition and protection of fundamental individual freedoms, in effect permanently withdrawing the subject matters of those freedoms from the vicissitudes of political controversy, be it in the electoral process, in the legislature, or in a multipartite industrial policy board.[59] Moreover, the ostensibly democratic nature of industrial policy is also economically irrelevant. For in a rational economy, the preferences of individual consumers, rather than those of a political elite, allocate resources and distribute income. Consumer sovereignty alone is economic democracy.

Furthermore, completely unrealistic is the notion that contemporary proposals for industrial policy are democratic in the meaningful sense that they involve large numbers of citizens actively participating in discussions concerning the economic direction their society should take. Because each of the many decisions involved in formulating a comprehensive industrial policy will have but a limited effect on the average citizen, and because expenditures of time on numerous other personal matters will be more profitable to him than studying the issues arising in the industrial policy debate, the average individual will remain rationally ignorant of the whole affair. Conversely, firms, unions, or public-interest groups that face significant economic or political gains or losses from one or another decision of the multipartite industrial policy board will intensely seek to involve themselves in the board's actions. Indeed, the very structure universally advanced for such a board—with private-sector representatives

[59]For example, West Virginia State Board of Education v. Barnette, 319 U.S. 624, 638 (1943); Gordon v. Lance, 403 U.S. 1, 6 (1971); Lucas v. Forty-Fourth General Assembly, 377 U.S. 713, 736–37 (1964); see Kingsley International Pictures Corp. v. Regents of New York University, 360 U.S. 684, 689 (1959); State v. Nemaha County, 7 Kan. 549, 555 (1871) (Brewer, J., dissenting).

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of business, organized labor, academia, the public-interest area, and the financial community, *but no representatives of the consumers generally, or of any other explicitly* pro-*market group*—evidences the proponents' intent that the board function as an exclusive forum for a selected range of speakers, rather than as an economic town meeting arguably open to all and sundry within the community.

Of course, the practical reality is that American firms and unions are already highly organized on an industry-by-industry basis to engage in political action through electoral support of candidates, lobbying, and wide-ranging propaganda—and therefore, as a matter of fact, already exercise significantly more political influence over governmental policies in the economic arena than do other, less-organized groups of citizens. However, the present state of political organization by firms, unions, and public-interest groups does not involve their representatives—*and their representatives alone*—in a *governmentally sponsored* forum where their views on economic policy—*and their views alone*—receive amplification in the national political debate *as a matter of law;* or, even worse, where the consensus of their views alone enjoys the force of law directly.

As currently structured, then, the proposed mechanism for deciding the nation's industrial policy is not at all democratic, but instead is palpably elitist. Each and every major scheme for a multipartite industrial policy board carefully excludes the public as a whole, or even the public specifically concerned with particular industries, from direct representation on or participation in the board as a legal right. Conversely, each and every major scheme explicitly includes representatives of the new class. Thus, vis-à-vis the general public, the proposals create for the benefit of the new class a legal inequality of opportunity to attempt to influence the political system. Moreover, in as much as the representatives of each subgroup of the new class are political appointees, they will predictably come from the most politically influential segments of the subgroups they ostensibly represent. Thus, vis-à-vis the minority or anti-establishment segments of those subgroups, the proposals create a further legal inequality of opportunity to exert political influence for the benefit of majority or establishment segments. In short, the multipartite industrial policy board will serve as a forum for political influence-peddling closed to everyone except the carefully culled mouthpieces of big business, powerful unions, fashionable academic circles, trendy public interest constituencies, and the financial elite of New York City and kindred metropolitan centers.

The political purpose of this exclusive forum is also clear: namely, the creation of an extra-constitutional institution for the limitless

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transmutation of property rights within American industry. A "symptom of America's political failure," industrial policy guru Robert Reich claims,

> is reliance on courts . . . to allocate the burdens and benefits of economic change. . . . But the courts are ill-equipped to settle such issues. These controversies are . . . political contests among whole segments of the population. Their resolution depends less on . . . fact or . . . law than . . . on widespread public discussion, negotiation, and consensus. . . . Law can resolve conflicts only through reference to shared principles. . . . Where legal controversy comes to be viewed as a mechanistic and arbitrary device . . . , law comes to be regarded with cynicism.[60]

To Reich, American society lacks "shared [legal] principles" concerning "the burdens and benefits of economic change." But in legal terms those burdens and benefits involve rights (or absences of right) to property. So, Reich is actually arguing that American society lacks "shared [legal] principles" regarding property; that in "controversies" over these burdens and benefits no rationally determinable legal rights are actually involved, only "mechanistic and arbitrary" allocations of the results of economic change; and that therefore economic change must realistically be perceived as a never-ending series of "political contests" to be settled by ad hoc and virtually ruleless "negotiation" and "consensus." How a consensus on distributions of economic burdens and benefits will emerge among people who lack "shared principles" regarding property Reich leaves unexplicated. What he does teach is that pervasive political redistribution is a basic premise of industrial policy. In the deliberations of the multipartite board, the mere legality of preexisting property rights will be no argument against a proposal for "allocat[ion]" of the burdens and benefits of change to suit the ephemeral fancies of the representatives of the new class. Bluntly put, the multipartite board will do what courts are "ill-equipped" to accomplish: dispense altogether with considerations of property law (including ex necessitate the relevant mandates of the Constitution's Due Process Clause[61]), and treat property as a purely political category.

In sum, the advocates of industrial policy propose nothing less than that an elite clique of representatives of the new class be ensconced in a special political forum in which they can negotiate among themselves how to redistribute other people's property

[60]Reich, *ante* note 4, at 271–72.

[61]U.S. Const. amend. V provides in pertinent part that "No person shall be . . . deprived of . . . property, without due process of law."

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throughout American industry and then either impose their consensus directly on society or launch a campaign of governmentally sponsored lobbying and political propaganda to foist their designs on the Congress and the American populus.

A Constitutional Critique of Industrial Policy Proposals

Although numerous aspects of contemporary proposals for industrial policy raise constitutional issues, a sufficient critique can focus on two basic concepts: namely, (i) that the national government should grant certain elite power blocs within the new class a special political forum through which to influence economic regulation by means of lobbying and propaganda (the multipartite board), and (ii) that the government should finance with taxpayers' monies non- or anti-market "investments" congenial to the social, economic, or political ideology of the new class (through an industrial bank).

The Absence of a Constitutional Basis for Public Subsidization of Industrial Policy

The second of these concepts perhaps most starkly reveals the unconstitutionally plunderous nature of industrial policy. For such schemes as the Bank for Industrial Competitiveness proposed in the Industrial Competitiveness Act amount to little more than a raid on the Treasury for the special benefit of particular businesses, unions, or geographical regions of the country that the country as a whole, through the market mechanism of rational cost accounting, has determined are insufficiently productive to warrant new or continued infusions of capital, but that the new class desires to subsidize anyway in defiance of the market. No sound constitutional basis exists, however, for such diversions of taxpayers' monies to private purposes.

Article I, section 8, clause 1 of the Constitution grants Congress "Power to lay and collect Taxes . . . to pay the Debts and provide for the . . . general Welfare of the United States." On its face, then, this clause denies the legitimacy of governmental support, directly or indirectly tax financed, for revitalization or innovation of particular private industries that the market mechanism of capital allocation—the one objective means for ascertaining the "*general* Welfare" in an economically meaningful sense—deems unworthy of investment. Indeed, the collection of monies intended for such a use is not by definition constitutional "taxation" at all, but simple spoliation, in as much as a "tax . . . signifies an exaction for the support of the Government. The word has never been thought to connote the

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expropriation of money from one group for the benefit of another."[62] To the contrary:

> To lay, with one hand, the power of the government on the property of the citizen, and with the other to bestow it upon favored individuals to aid private enterprises and build up private fortunes, is none the less a robbery because it is done under the form of law and is called taxation. . . .
>
> [T]here can be no lawful tax which is not laid for a public purpose.[63]

Thus, in as much as contemporary proposals for industrial policy clearly aim at subsidization of particular businesses, they are invalid for want of a public purpose. And they would be no less unconstitutional if ostensibly directed at supporting particular local regions, or states, rather than private parties.[64]

Of course, that the question of the public purpose of taxation is a justiciable one,[65] that the courts may disregard purported congressional "findings" on the subject and investigate the matter independently,[66] and that in a "plain case" they may "se[t] aside the conclusion of Congress,[67] does not necessarily augur judicial invalidation of industrial policy. For the courts also afford Congress wide discretion in the premises,[68] and have evidenced reluctance to confer standing on either private individuals or states to challenge Congress' policies in the areas of taxation and spending.[69] Which emphasizes the need for a market-oriented president to take decisive action on constitutional grounds to thwart the installation of national industrial policy at the very onset.[70]

Article I, section 8, clause 3 of the Constitution grants Congress the power "To regulate Commerce . . . among the several States."

[62]United States v. Butler, 297 U.S. 1, 61 (1936).

[63]Citizens' Savings & Loan Association v. City of Topeka, 87 U.S. (20 Wall.) 655, 664 (1875). *Accord*, Cole v. City of La Grange, 113 U.S. 1, 6–7 (1885); City of Parkersburg v. Brown, 106 U.S. 487, 500–01 (1882); Jones v. City of Portland, 245 U.S. 217, 221 (1917). See also Missouri Pacific Railway v. Nebraska, 164 U.S. 403, 416–17 (1896); Thompson v. Consolidated Gas Utilities Corp., 300 U.S. 55, 77–80 (1937).

[64]See United States v. Gerlach Live Stock Co., 339 U.S. 725, 738 (1950); Cincinnati Soap Co. v. United States, 301 U.S. 308, 317 (1937).

[65]See Milheim v. Moffat Tunnel District, 262 U.S. 710, 717 (1923); Rindge Co. v. County of Los Angeles, 262 U.S. 700, 705–06 (1923).

[66]A. L. A Schechter Poultry Corp. v. United States, 295 U.S. 495, 538 (1935); Chastleton Corp. v. Sinclair, 264 U.S. 543, 547–49 (1924); Prentis v. Atlantic Coast Line Co., 211 U.S. 210, 226–27 (1908).

[67]Cincinnati Soap Co. v. United States, 301 U.S. 308, 313 (1937).

[68]For example, Helvering v. Davis, 301 U.S. 619, 640–41 (1937).

[69]Frothingham v. Mellon, 262 U.S. 447, 486–88 (1923); Massachusetts v. Mellon, 262 U.S. 447, 482–86 (1923). But see Flast v. Cohen, 392 U.S. 83, 102–05 (1968).

[70]See Vieira, *ante* note 40, at 379–91.

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On its face, too, this clause denies the legitimacy of governmental intervention aimed at securing profits for or subsidizing losses of particular private businesses. "Commerce," after all, exhibits two essential features: (i) *consensual* activity among investors, producers, and consumers, and (ii) terms of trade determined by considerations of profit *and loss*. Therefore, if the government guarantees an industry's profitability by coercing investors, producers, and consumers in their roles as taxpayers to support that industry financially, it is self-evidently not regulating "commerce" but *replacing* it with a species of "lemon socialism" or "lemon fascism."

Moreover, the purpose of the Constitution's Commerce Clause is to preserve a national "common market," free from interference designed to privilege local interests economically at the expense of the country as a whole.[71] Industrial policy, however, is fundamentally at odds with this purpose, aiming instead precisely at the creation of numerous governmentally financed economic privileges for particular private businesses, industries, unions, or geographical regions that disserve the national economic welfare. Where individual states have attempted to thwart the constitutional command of a national common market through local industrial policies, the courts have never hesitated to declare such protectionism invalid. Even under the purported exigency of economic distress,[72] no state may "place itself in a position of economic isolation" from the rest of the country;[73] attempt to "suppress," "mitigate," "neutralize," or "protect its own citizens" from the consequences of economic competition from other states;[74] or command that "business operations . . . be performed [there] that could more efficiently be performed elsewhere."[75] Rather, such interference with the free flow of commerce throughout the country is unconstitutional per se.[76] Why the same rule should not apply to Congress where its industrial policy specifically aims at the selfsame ends for the benefit of certain states (or worse, private parties) and to the detriment of the country as a whole is difficult to fathom.

The states, after all, lost their original authority to intervene in interstate markets when the Constitution granted the commerce power

[71]Hunt v. Washington State Apple Advertising Comm'n, 432 U.S. 333, 350 (1977).

[72]Baldwin v. G.A.F. Seelig, Inc., 294 U.S. 511, 522–23 (1935).

[73]Ibid., at 527.

[74]Ibid., at 521–22, 525–26; Lewis v. BT Investment Managers, Inc., 447 U.S. 27, 43–44 (1980).

[75]Pike v. Bruce Church, Inc., 397 U.S. 137, 145 (1970).

[76]Lewis v. BT Investment Managers, Inc., 447 U.S. 27, 36–37 (1980); Minnesota v. Clover Leaf Creamery Co., 449 U.S. 456, 471 & n.15 (1981).

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to Congress.[77] But the power Congress enjoys in that regard is one to regulate commerce "among the several States" taken as a collectivity—implying with no little clarity that the ambit of congressional authority excludes protectionist legislation designed to favor one, or a group, of states at other states' expense.[78] Industrial policy, though, seeks to place favored states (or industries therein) in positions of economic isolation, to suppress competition (especially in interstate markets for labor and capital), and to impede business mobility generally for the purpose of protecting citizens in one region from the socially progressive effects of national market forces. If even a majority of states lacks constitutional license to take such action independently, their claimed ability to do so through a majority of the members of Congress—where their candidly avowed purpose is to defeat the very end of the Commerce Clause—lacks a logical basis.

Under any provision of the Constitution, legislation must exhibit a rational basis to survive judicial review. The purpose of industrial policy is to give economic advantages to persons engaged in certain businesses—in particular, protection from competition for capital, labor services, and other factors of production. Furthermore, these advantages are to accrue only on a discriminatory basis—specifically, according to the determination of a multipartite board or bank composed of representatives of the new class that the favored businesses will engage in the kinds of revitalization or innovation that the board or bank, not the public expressing its preferences through the market, deems acceptable. Governmental favoritism of this sort, however, is arbitrary and unreasonable on its face, violating the fundamental constitutional rule of equal protection of the law.[79]

Finally, Congress cannot obviate these serious constitutional objections to industrial policy by arranging for subsidization of the new class's favored industries with monies from private union-management pension funds. Instead, such subsidization would itself raise grave constitutional problems under the First Amendment.

Monies contributed to the employer-employee pension funds subject to the Employee Retirement Income Security Act[80] are, economically speaking, the deferred wages of employees, which have been coercively diverted from the employees' take-home pay under the

[77]Lewis v. BT Investment Managers, Inc., 447 U.S. 27, 35–36 (1980).

[78]On the use of the term "the several States" to refer to *all* the States, see U.S. Const., art. II, § 2; art. IV, § 2. See also U.S. Const., art. VI, cl. 3.

[79]Compare Mayflower Farms, Inc. v. Ten Eyck, 297 U.S. 266, 273–74 (1936), with Bolling v. Sharpe, 347 U.S. 497, 499–500 (1954), Steward Machine Co. v. Davis, 301 U.S. 548, 585 (1937), and Currin v. Wallace, 306 U.S. 1, 13–14 (1939).

[80]29 U.S.C. §§ 1001–1461.

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aegis of collective-bargaining agreements negotiated between employers and unions. As interpreted by the courts, the national labor laws do not permit employers, unions, or employers acting in concert with unions through collective bargaining to divert any monies from dissenting employees' incomes to political or ideological causes that those employees oppose.[81] And if the labor laws did not embody this prohibition themselves, the Constitution would impose it, perforce the First Amendment guarantees of freedom of speech, assembly, petition, and association.[82]

No one can dispute that the investments of the typical industrial bank contemplated by the advocates of industrial policy will amount to what is euphemistically labeled "social investing": that is, combining a market investment with the support of some non- or anti-market political or ideological goal, notwithstanding the risk of financial loss.[83] Therefore, private pension fund fiduciaries who invest in bonds or other obligations of such an industrial bank will thereby be engaging in social investing. To be sure, the Industrial Competitiveness Act requires that any revitalization or innovation loan the bank extends or guarantees have a "reasonable" expectancy of return and ultimately be supported by the "full faith and credit" of the national government—which argues for the financial security of any pension fund investment in the bank's own paper. Even if it exists, however, this financial security is legally irrelevant. For, through the bank's loans, the pension fund's investments in the bank will necessarily amount to a loan of employees' monies for the political and ideological purposes of the new class, purposes which (in the vast majority of cases) are unknown to the employees, and probably would be opposed by many of them if they were aware of what was going on.

Certainly, it is too late to argue that it would be legal for employers and unions to agree through collective bargaining to withhold a percentage of employees' take-home pay and contribute it to some industrial revitalization or innovation that they deemed socially valuable, on the promise that the employers and unions, later on, would repay the forced loan with adequate interest.[84] Why it would be any less illegal for employers and unions, in league with pension fund fiduciaries and the managers of an industrial bank, to achieve the same end by an economically identical operation labeled "investment" is difficult to see. Thus, whether an industrial bank obtains its

[81]Ellis v. Railway Clerks, 104 S. Ct. 1883 (1984).

[82]Abood v. Detroit Board of Education, 431 U.S. 209 (1977).

[83]See Vieira, *ante* note 36, at 1–7.

[84]Ellis v. Railway Clerks, 104 S. Ct. 1883, 1889-90 (1984).

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capital from the taxpayers or from private pension funds, its operations raise serious constitutional problems.

The Absence of a Constitutional Basis for Enhancing the Political Influence of the New Class

The constitutionally novel aspect of contemporary proposals for industrial policy lies, not in their reliance on taxpayers' (or even pension funds') monies to subsidize non- or anti-market activity, but instead in their advocacy of multipartite boards composed of representatives of the major power blocs of the new class and licensed to exert strong political influence on Congress at the public's expense in support of the new class's socioeconomic agenda. Under the Industrial Competitiveness Act, for instance, the members of the multipartite board and bank consist of one public group, "heads of Federal departments or agencies, Members of Congress, or representatives of State or local governments," and four private groups, including "national leaders with experience and background in business"; "national leaders with experience and background in the labor community"; persons "from the academic community or . . . active in public interest activities"; and individuals "who have substantial experience and expertise in the fields of business investment, industrial development, or public or private finance."[85] Little cynicism is necessary to anticipate that only people who enthusiastically embrace the interventionistic premises of the act will be selected to fill these positions: businessmen in favor of governmental bail-outs, such as Lee Iacocca; labor leaders from the AFL-CIO; academicians such as Robert Reich and Lester Thurow; and financial experts such as Felix Rohatyn. In any event, the vast majority of the members of the board and bank will represent, *and be chosen precisely because it represents*, certain private economic and political special-interest groups. Other private special-interest groups—such as consumers, nonunion employees, small businesses not organized in mammoth trade associations, rigorous free-market economists, and so on—will receive *no* representation at all, notwithstanding their equal interest in influencing the direction of industrial policy in this country.

Moreover, under the Industrial Competitiveness Act, the multipartite board will be empowered to create a forum, open to the representatives of the new class but closed to everyone else, in which to "identify national economic problems"; "develop recommendations to address such problems"; "create a broad consensus in support of such recommendations"; "provide policy recommendations

[85]H.R. 4360, 98th Cong., 2d Sess., §§ 103(a), 202(b).

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and guidance to the Congress, the President, and the Federal departments and agencies"; and "consult with" appropriate committees of Congress concerning its recommendations.[86] And the congressional committees will be *required* to submit to Congress "report[s] setting forth the views and recommendations of such committee[s] with respect to the report of the [board]."[87]

Thus, overall, the act provides the new class with its own governmentally sponsored and taxpayer-subsidized platform from which to launch a campaign of lobbying and political propaganda to which Congress, in particular, will be compelled by law to pay attention. The act thus creates a dichotomy of legal opportunity to exert political influence between the specially privileged representatives of the new class on the one hand and everyone else on the other. Furthermore, it creates this dichotomy with relation to the singularly divisive political issue of industrial policy, affording one side in the debate an ability to promote its position denied to the other.

On its face, then, the multipartite-board approach offends the First Amendment's guarantee of free speech, because it involves the government in enhancing the political speech of one group in order to attenuate the relative voices of others; and it distorts the government's decision-making processes in order to benefit one group at everyone else's expense.[88] Indeed, the offense is patent, in light of the unequivocal precept that "[t]o permit one side of a debatable public question to have a monopoly in expressing its views to the government is the antithesis of constitutional guarantees."[89]

In a series of cases involving the right to vote, the Supreme Court has ruled without exception or qualification that political discrimination is unconstitutional, even if it arguably promotes or defeats "good" or "bad" political views; balances political power among competing interest groups; encourages "political stability"; solves "practical [political] problems"; aids or hinders particular economic, social, or other nonpolitical interests; recognizes the "special pecuniary or other interest" of some group in a governmental decision; takes employment status into account; or even satisfies the demands

[86]Ibid., §§ 102(4, 6), 107(c)(2).

[87]Ibid., § 107(c)(2).

[88]See, mutatis mutandis, First National Bank of Boston v. Bellotti, 435 U.S. 765, 790–92 (1978); Washington v. Seattle School District No. 1, 102 S. Ct. 3187, 3193–95 (1982).

[89]City of Madison, Joint School District No. 8 v. WERC, 429 U.S. 167, 175–76 (1976) (footnote omitted).

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of majorities.[90] No rational basis exists for relaxing this fundamental tenet of democratic government simply because lobbying and propagandizing, but not voting, are involved; for lobbying and propagandizing are as much important political activities as exercising the franchise.[91] No rational basis exists for disregarding the rule simply because the political-economic interests of the new class are at stake; for the First Amendment—or the Constitution as a whole—extends no special privileges or protections to any special-interest group.[92] And no rational basis exists for relaxing the constitutional guarantee simply because the discriminatory political privileges relate solely to the issue of industrial policy; for the First Amendment recognizes no hierarchy of protection for different types of speech,[93] or based on the content thereof.[94]

In short, the constitutionally sufficient rejoinder to the demand for a multipartite board to generate industrial policy is that

> government may not grant the use of a forum to people whose views it finds acceptable, but deny use to those wishing to express less favored . . . views. And it may not select which issues are worth discussing or debating in public facilities. There is an "equality of status in the field of ideas," and government must afford all points of view an equal opportunity to be heard.[95]

A fortiori, a multipartite board with prescriptive, as well as merely consultative or advisory, authority would also be unconstitutional.[96]

[90]Cipriano v. City of Houma, 395 U.S. 701, 704–06 (1969); Carrington v. Rash, 380 U.S. 89, 93–94 (1965); Davis v. Mann, 377 U.S. 678, 691–92 (1964); Gray v. Saunders, 372 U.S. 368, 379–80 (1963); Williams v. Rhodes, 393 U.S. 23, 31–32 (1968); Kirkpatrick v. Priesler, 394 U.S. 526, 533 (1969); Lucas v. Forty-Fourth General Assembly, 377 U.S. 713, 736–37, 738 & n.31 (1964); City of Phoenix v. Kolodziejski, 399 U.S. 204, 208–10 (1970); Evans v. Cornman, 398 U.S. 419, 422–26 (1970); Kramer v. Union Free School District, 395 U.S. 621, 630–33 (1969); Harper v. Board of Elections, 383 U.S. 663, 666 (1966).

[91]See Vieira, "Are Public-Sector Unions Special Interest Political Parties?", *DePaul L. Rev.* 27 (1978): 293, 332–44.

[92]For example, labor unions are entitled to no special constitutional status as against any other group. Smith v. Local 1315, Highway Employees, 441 U.S. 463, 464–65 (1979); Carey v. Brown, 447 U.S. 455, 466–67 (1980); Chicago Police Department v. Mosley, 408 U.S. 92, 100–02 (1972); Thomas v. Collins, 323 U.S. 516, 538 (1945). See also City of Charlotte v. Local 660, Firefighters, 426 U.S. 283, 286 (1976); Coppage v. Kansas, 236 U.S. 1, 16–17 (1915).

[93]For example, Stanley v. Georgia, 394 U.S. 557, 565–66 (1969); Winters v. City of New York, 333 U.S. 507, 510 (1948); Lehman v. City of Shaker Heights, 418 U.S. 298, 318–20 (1974) (Brennan, J., dissenting).

[94]For example, Cohen v. California, 403 U.S. 15, 24 (1971); Street v. New York, 394 U.S. 576 (1969); New York Times Co. v. Sullivan, 376 U.S. 254, 269–70 (1964); NAACP v. Button, 371 U.S. 415, 445 (1963).

[95]Chicago Police Department v. Mosley, 408 U.S. 92, 96 (1972).

[96]See A.L.A. Schechter Poultry Corp. v. United States, 295 U.S. 495, 537 (1935).

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Conclusion

At base, contemporary proposals for industrial policy are an attempt to circumvent the strictures of the Constitution regarding inter alia the expenditure of taxpayers' monies, regulation of interstate commerce, and political equality. Thus, besides being economically unsound, industrial policy is also illegal. Such demerits, however, have not always been sufficient to thwart the enactment of other governmental programs in the past or to guarantee their invalidation by the courts. One thing is clear, though: If Congress enacts an industrial policy bill of the sort now proposed, and the Supreme Court sustains its constitutionality, that event will mark a radical departure from traditional constitutional principles of republican government and toward outright fascism.

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THE POLITICAL ECONOMY OF NATIONAL INDUSTRIAL POLICY

Thomas J. DiLorenzo

Introduction

The phrase "national industrial policy" (NIP) can be viewed as a euphemism for national economic planning and an expanded welfare state.[1] This can be seen by examining some of the NIP proposals, which include greater governmental control over credit allocation, government domination of plant-closing decisions, governmental promotion or penalization of "winning" and "losing" industries through selective tax and subsidy schemes, and legislatively enacted co-determination.[2] Although the volume and variety of NIP proposals is mind boggling, the current debate over national industrial policy centers on one basic issue: Does economic growth best proceed through the spontaneous forces of the market or the coercive powers of the state? In short, the debate over industrial policy concerns the basic role of government in a free society: Should the powers of the state be used to cultivate the market order or to supersede the market and replace planning by individuals with planning by government bureaucracies? According to Hayek (1978, p. 234), this and other disputes over economic planning really hinge upon whether

> it is better that the holder of coercive power should confine himself in general to creating conditions under which the knowledge and initiative of individuals are given the best scope so that *they* can

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[1]Few NIP advocates voice a preference for comprehensive national economic planning in view of the debacles created by all previous attempts. Instead, they urge more of a "halfway house" between comprehensive economic planning and a free market economy. As shown below, such partial attempts are doomed to fail for the same reasons comprehensive planning has failed.

[2]For an overview of these proposals see McKenzie (1983).

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> plan most successfully; or whether a rational utilization of our resources requires *central* direction and organization of all our activities according to some consciously constructed 'blueprint.'

This paper evaluates the current NIP proposals by first explaining the general economic consequences of the "protective state" that facilitates market exchange and economic efficiency, and the "redistributive state" that arbitrarily directs the organization of individual activity according to political criteria. It is shown how government promotes economic cooperation and prosperity when it is restricted to protecting private property rights and the freedom of exchange, and how the redistributive or "planning" role of government leads to economic conflict, stagnation, and a loss of individual liberty.

The adverse effects of government planning are illustrated by examining the consequences of the NIP proposal to extend greater governmental control over the allocation of credit. It is explained how NIP proponents are deluded by the fallacious assumption that politics is inherently "cooperative" whereas market behavior is conflictual, and is therefore the source of economic instability. This is followed by a discussion of how the current debate over industrial policy is part of an ongoing struggle by political forces to supersede the market economy.

Markets, Politics, and Economic Growth

The market is a process in which individuals voluntarily interact with one another in pursuit of their own interests. With appropriately designed institutions—such as well-defined, enforced, and respected property rights and freedom of contract, freedom of exchange, and the enforcement of contracts—self-interested behavior generates a spontaneous order. This order is chosen by no one, yet it tends to maximize the subjective values of all the market participants. Only in this sense can the market process be termed "efficient." The maximization of subjective values, as individuals perceive them, is the end result of the market process and cannot be defined or "maximized" by any outside observer. A market situation can be judged "efficient" to the extent that it allows individuals to exercise their preferences subject only to the principles of mutual agreement and noninterference with the equal rights of others. The determination of what is efficient by some third party, such as government, would require interpersonal utility comparisons that are arbitrary and meaningless. In the absence of an omniscient and benevolent despot, market efficiency can be defined only in terms of the extent to which

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existing institutions facilitate mutually advantageous trade, subjectively valued.

Voluntary trade is a positive-sum game that increases the wealth of nations *as long as rights are exclusive.* That is, as long as property rights are defined, enforced, and transferable, productive activity will take place. If, by contrast, rights are attenuated, less trade and productive activity will take place. This amplifies the importance of one role that government has played in the economic system: the definition and enforcement of property rights. By establishing and enforcing the "rules of the game," government can encourage market efficiency and productive activity.

Of crucial importance is the protection of a well-functioning price system, for it provides the information individuals need to coordinate their plans and to engage in trade. Through the process of competition the price system reveals information on changing consumer preferences, changing relative scarcities, alternative levels of risk, and other information that is invaluable to decision makers, whether they are consumers or businessmen.

The fatal mistake of NIP proponents is that they ignore the fact that only through the competitive market process can we learn, via the price system, the relevant information for making economic decisions. To the extent that NIP proposals interfere with the price system (and they would), economic decision making and economic efficiency would be impaired. As Hayek stated (1978, p. 236):

> The chief reason why we cannot hope by central direction to achieve anything like the efficiency in the use of resources which the market makes possible is that the economic order of any large society rests on a utilization of the knowledge of particular circumstances widely dispersed among thousands or millions of individuals. . . . But among the alternative possibilities for coping with these difficulties—either conveying to a central directing authority all the relevant information possessed by the different individuals, or communicating to the separate individuals as much as possible of the information relevant for their decisions—we have discovered a solution for the second task only: the market and the competitive determination of prices have provided a procedure by which it is possible to convey to the individual managers of productive units as much information in condensed form as they need in order to fit their plans into the order of the rest of the system.

Furthermore, as an economy gains in size and complexity, it becomes even more necessary to rely on the market; for it is the only known mechanism that can effectively deal with such complexity. Subjecting private decision makers to further governmental interference through credit "controls," plant-closing boards, and other means can

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only increase uncertainty in the minds of entrepreneurs who must then refocus their efforts from serving consumers to dealing with red tape, directives, and regulations.

Thus, if economic growth is the objective, the most effective "industrial policy" would be for government to protect private property rights, safeguard freedom of trade and contract, and preserve the price system. In short, the proper role for government is to be the referee who watches over and enforces these rules of the game.

Politicial Resource Allocation

In recent decades the government's role has shifted away from being a referee to actively rearranging and redistributing property rights. In modern politics, ownership rights are not well respected. The state seems to operate with the notion that those within government can lay claim to all property rights and have the power to rearrange these rights arbitrarily through legislation. As individuals, politicians and bureaucrats are no different than the rest of us: They too prefer more rights to the use of resources to less and seek to maximize their utility. The utility of the politician or bureaucrat, however, is not enhanced primarily by acquiring ownership rights in goods and services through market activity. Politicians and bureaucrats gain access to goods and services by using their positions in government to bestow special privileges—to rearrange property rights—in favor of politically active individuals or groups. They do this in exchange for votes, campaign contributions, and other forms of political support. And they can do so at little cost; for those whose rights are consequently abridged are usually not politically well organized. In essence, the attenuation of property rights is the business of modern politics, and always has been. Politicians are continually seeking to expand the market for their services. Stability in private property rights is anathema to them because it imposes constraints on their abilities to accumulate power and wealth. Bernard Siegan (1980) has shown that since the early 1940s, there has been a progressive attenuation of property rights in the United States. The Supreme Court has failed, in effect, to protect our economic liberties by letting the legislative branch redistribute property almost at will.

The net effect of political resource allocation is to inhibit trade and production by reducing the expected benefits (for example, by restricting land use) and by increasing the costs. As more rights and resources come under political control, the returns to lobbying and other forms of political activity increase. This reduces the nation's productive capacity even further, because many of the resources spent by individuals and groups who seek special interest legislation

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are necessarily withdrawn from the process of production. Thus, by defining and enforcing property rights the state encourages productive activity, whereas by redefining and reallocating rights and interfering with the price system the state discourages production and encourages rent-seeking behavior.[3]

The importance of the government's role in protecting rather than rearranging property rights has long been recognized. Over 100 years ago Frédéric Bastiat wrote that governmental attempts to redistribute income will create "a frightful uncertainty . . . over the whole domain of private activity" (1964, p. 127). The value of individual responsibility, said Bastiat (1860, p. 10), will then be rendered

> more and more inert and inefficacious. By an improper application of the public force [to redistribute income], we alter the relation of labour to its remuneration, we disturb the laws of industry and of exchange . . . we give wrong direction to capital and labour. . . .

Bastiat (1964, p. 128) feared that once it is accepted among citizens that it is "legitimate" for government to arbitrarily redistribute income,

> we shall see the entire people transformed into petitioners. Landed property, agriculture, industry, commerce, shipping, industrial companies, all will bestir themselves to claim favors from the state. The public treasury will be literally pillaged.[4]

In sum, the NIP proposals, by expanding the domain of rent-seeking behavior, are inherently biased toward stifling, not stimulating, economic growth. As economic growth takes place over time, circumstances constantly change; and the market system best facilitates adaptation to change. Since it is precisely this adaptation that NIP proposals will delay or eliminate, they will stifle the source of long-term economic growth only for the short-term benefit of a few powerful special interests, including various businesses, unions, and other groups. As Hayek (1979, p. 94) recently noted, the social benefits of competitive markets and economic growth "are the results of such changes, and will be maintained only if the changes are allowed to continue." But every change hurts some organized interests; thus the preservation of the market order hinges upon our ability to stop these interests from preventing, through government, changes they do not like. Perhaps the major NIP proposal is for an expanded role of government in the allocation of capital. This practice provides a clear example of how allocating resources through politics rather

[3]Tollison (1982) provides a survey of the rent-seeking literature. Olson's (1982) work includes empirical estimates of the effects of rent-seeking behavior on economic growth.
[4]See Dorn (1981) for a fuller discussion of Bastiat's ideas on the role of government.

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than markets benefits only a few at great expense to the rest of the nation.

The Political Economy of Government Credit Allocation

One of the most common themes of NIP enthusiasts is that there is an alleged need to "reindustrialize America . . . through a new partnership between government, management and labor" (Kirkland 1982, p. 20). That is, the market should be replaced by a "panel of experts," including businessmen, politicians, and union leaders. Lane Kirkland (1982, p. 20), president of the AFL-CIO, holds a view that all NIP proponents seem to share. He proposes

> the creation of a tripartite National Reindustrialization Board—including representatives of labor, business, and government—which would . . . insure the revitalization of the nation's sick industries and decaying communities, while at the same time encouraging the development of new industries with promise for the future. . . . This board would also direct the activities of a financing agency, patterned after the Reconstruction Finance Corporation of the 1930s and 1940s, which would be authorized to make and guarantee loans to finance approved reindustrialization ventures.

Proponents of a new Reconstruction Finance Corporation (RFC) claim benefits that such a program could not possibly produce. Supposedly an RFC is needed to better pursue "the longer-term perspective of the needs and aspirations of the American people" and to "target industrial sectors and regions that particularly need help" (Kirkland 1982, p. 21). It is impossible, however, for a government "planner" to obtain results that are superior (or even similar) to what an unregulated market economy can produce. Resource allocation by a resurrected RFC would subvert the role of the price system in allocating resources to their highest-valued uses, a role which, ironically, RFC proponents claim to be one of their chief objectives.

The idea that an RFC can improve the allocation of resources by "targeting" certain industries is absurd, regardless of the good intentions of its proponents. For this to be feasible, one must assume that government bureaucrats would be consistently better at forecasting consumer demands than are private firms and therefore will make better use of information (on behalf of consumers) than will private entrepreneurs. This argument is inherently flawed. In the private sector those firms that fail to accurately anticipate or forecast changes in consumer demands will not prosper and may not survive. Only firms that can best anticipate consumer demands and channel resources

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accordingly will survive in the marketplace. Those individuals and firms that have all the detailed knowledge of particular industries—knowledge of consumer tastes, the likely success of various technological advances, changes in relative scarcities of raw materials, and so on—are best able to "plan" for the future. By contrast, government bureaucrats are subject to no such forces. Failure to correctly and consistently forecast consumer demands is not met with "losses," for there are no profits or losses, in an accounting sense, in the public sector. Moreover, the bureaucrat often judges failure as success, because this provides him with opportunity to make a plea for even more funding for his bureau.

Government bureaucrats, by definition, are detached from the everyday workings of an industry and simply cannot plan as effectively as can private individuals or firms. They are not in a position to obtain all the "information of time and place" that is necessary to operate successful business enterprises (namely, ones that satisfy consumers), even if they had an incentive to do so. It is odd that in light of the well-documented failure of government bureaucracies to plan their own affairs efficiently, NIP proponents are attempting to convince the public that additional governmental control over *private* enterprise is desirable. Moreover, only the competitive market process can reveal the appropriate information in the first place.

An RFC would also subvert the very important role credit markets play in allocating risk. Credit markets evaluate the riskiness of alternative projects, and those with higher probabilities of failure (to meet consumer demands) are charged higher borrowing costs. In this way the credit markets give consumers and producers invaluable information about the most productive uses of resources. By socializing risk an RFC would make it impossible for consumers and producers to make truly accurate benefit-cost calculations; and resources are put to lower-valued, not higher-valued, uses once politics is used to allocate credit. For example, at times when high interest rates force private firms to invest in only the most productive projects promising very high yields, politically favored firms and industries would invest in projects yielding only a fraction of the return of the "unfavored" investments. Thus, by subsidizing economically inefficient but politically popular investments, an RFC would surely reduce the productivity of the nation's capital stock, thereby *lowering* the rate of economic growth.

In sum, by interfering with the market allocation of credit, governmentally controlled credit allocation would be very harmful to the nation's economy, even though it may confer short-lived benefits on politically favored industries, unions, and regions.

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Political Versus Market Allocation of Capital

The establishment of an RFC is directly at odds with the growth-facilitating forces of the price system and, therefore, with consumer sovereignty. The whole purpose of an RFC is to prevent the price system from allocating resources and, instead, to assign that task to selected politicians, bureaucrats, businessmen, and union leaders. The creation of an RFC would convey the message that consumers are no longer to be trusted to register their true preferences via the price system. Rather, government bureaucrats would inform us what our preferences are and then "target" governmentally controlled credit into those areas. But even if government authorities were omniscient and could read the consumers' minds, there is no reason to believe that resources would be used efficiently. Equity, however defined, is equally unlikely, and political resource allocation often generates greater inequities than does the market. How politicians allocate resources under their control will depend on their perceptions of the personal benefits, such as votes and campaign contributions, that accrue from alternative allocations. As James Buchanan observed (1977, p. 13):

> Politicians are politicians because they want to be. They are no more robots than other men. Yet the politician who would do nothing other than reflect the preferences of his constituents would, in fact, be robotlike in his behavior. Few, if any, politicians are so restricted. They seek office because they seek 'profit' in the form of 'political income' which will normally be obtained only if their behavior is not fully in accord with the desires of electoral majorities. Those men who are attracted to politics as a profession are likely to be precisely those who have considerable interest in promoting their own version of good government, along with those who see the opportunities for direct and indirect bribes, and those who evaluate political office as a means toward other ends.

And as Senator William Proxmire stated during the July 25, 1983, Senate debates on industrial policy:

> Money will go where the political power is. . . . It will go where the union power is mobilized. It will go where the campaign contributors want it to go. It will go where the mayors and governors as well as congressmen and senators have the power to push it. Anyone who thinks government funds will be allocated to firms according to merit has not lived or served in Washington very long.[5]

Thus, an RFC can be expected to allocate credit in a way that is the most profitable politically: It will reward the most politically

[5]Cited in Poole (1983, p. 6).

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active unions, industries, and regions. Such a strategy will promote "reindustrialization" only by accident. It can be expected to stifle economic growth by subsidizing economically inefficient but politically popular firms and industries.

The role of the federal government in allocating credit did not end with the original RFC in the mid–1950s. The RFC was just one among many tools used by federal politicians to control the allocation of credit during the Great Depression, and many of its remnants are alive and well. A survey of some of these practices will help in understanding the consequences of political credit allocation.

Loan Guarantees and the Allocation of Credit

Proponents of a new RFC rarely mention that in addition to about $30 billion in direct loans, there are already more than 150 federal loan guarantee programs administered by federal agencies that guide the allocation of more than $100 billion in loans annually.[6] Loan guarantees are part of the legacy of the original RFC, and expanded guarantees are an integral part of the more recent proposals.

The costs of federal loan guarantee programs, like the benefits, are indirect. A major difference, however, is that the benefits accrue to well-organized interest groups but the costs are widely dispersed among the general public. The predominant indirect cost of federal loan guarantees is borne by less-favored borrowers who are crowded out of the credit market or who must pay higher interest rates on the loans that are obtained. Loan guarantees tend to increase the overall demand for credit while at the same time reducing the supply of credit available to nonguaranteed borrowers. The effect is to increase the rates charged to nonguaranteed borrowers to levels higher than they would otherwise be, which crowds out much private borrowing. This seriously distorts the market process whereby unregulated markets allocate credit to its most highly valued uses, enhancing economic growth.

As an example of how private-sector investments are crowded out in favor of government-sponsored investments, consider the following: In 1980, when a 20 percent prime rate and a 16 percent consumer loan rate contributed to the bankruptcy of thousands of small businesses, such as auto dealerships and grocery stores, the Rural Electrification Administration began a new program to provide 35–year loans at 5 percent interest to finance rural cable television systems; rural home mortgages were available at 3.3 percent; and insured student loans went for 7 percent. Also during that year, while many

[6]The following discussion is based on Bennett and DiLorenzo (1983).

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private utilities were paying 16 percent on their long-term bonds, the Tennessee Valley Authority (TVA) was borrowing at a rate that was several percentage points lower. As a result of this and other subsidies, the cost of electricity supplied by TVA is lower than it is in many areas served by less-favored private companies. In 1979, for example, TVA rates were about 50 percent lower than rates in such "frostbelt" states as New York and Massachusetts and about 38 percent below the national average.

It is very difficult, if not impossible, to gauge the extent of crowding out caused by federal loan guarantees, but some preliminary estimates have been made. Economist Herbert M. Kaufman of the University of Arizona conducted an empirical study of federal loan guarantees, in which he estimated that for every $1 billion in loan guarantees, between $736 million and $1.2 billion in private investment is crowded out. These are rough estimates, but they indicate that loan guarantees, which are being extended at a rate of over $100 billion per year, are certain to have a profound, negative impact on economic growth, employment, and price stability.

The federal government uses loan guarantees in a more subtle way to control the allocation of resources by influencing the recipients. For example the Federal Housing Administration (FHA), which administers the largest loan guarantee program, attempts to implement various social policies by vetoing a loan application if a builder does not comply with FHA's regulations regarding marketing to minority groups, environmental impact statements, architectural review, underwriting minimum wages, and so on. Because of the division of responsibility for these objectives, there is considerable confusion and delay, which increases the cost of housing construction. Further, once a firm or an industry is dependent upon financial assistance from the government, the dependence is often used as a lever to impose additional regulatory controls that may be totally unrelated to the government's contingent liability.

Equity Aspects of Federal Loan Guarantees

In addition to fostering a less efficient allocation of resources and hindering economic growth, many of the loan guarantee programs would be considered by many to be inequitable. An extreme case is the student loan program that, with few eligibility requirements, creates generous subsidies for higher-income households. With such loans available to students and their parents at a 7 percent interest rate regardless of income, the high market interest rates of the late 1970s and early 1980s provided many lucrative investment opportunities for wealthy families. As the spread widened between interest

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rates on student loans and market rates, new student loans rose from $2.7 billion in 1979 to $7.2 billion in 1981, reflecting the growing recognition of the opportunities to borrow thousands of dollars at 7 percent interest and invest the proceeds in long-term bonds or money market funds paying 14 to 16 percent. Futhermore, hundreds of millions of dollars in student loans are now in default, rendering these loans outright gifts to the students and their parents.

Regardless of the rhetoric associated with such programs, the vast majority of federal loan guarantee programs provide subsidies to individuals who are not generally considered to be financially disadvantaged. There is a very strong incentive for the administrators of loan guarantee programs to subsidize politically powerful groups, regardless of income, who will, in return, provide support for the agency at appropriations time. Even though the chief goals of the Department of Housing and Urban Development (HUD) are supposedly "the elimination of substandard and inadequate housing through the clearance of slums and blighted areas," it has established hundreds of programs that have nothing to do with slum clearance. For example, HUD's housing rehabilitation loan program has extended 3 percent guaranteed loans to individuals earning over $50,000 per year to finance skylights and greenhouses.[7]

If there is a pattern of behavior that guides the granting of federal loan guarantees, it is based on the ability of the subsidized group to provide political support for the agency and its legislative sponsors, and not on efficiency or equity grounds. There is no reason to believe that a new RFC would behave any differently. Additional loan guarantees are an integral part of the current proposals for a resurrected RFC and would undoubtedly inflict further harm on the economy.

NIP enthusiasts apparently believe that the original RFC was a success, for its resurrection is the main plank in their industrial policy platform. A closer look at Hoover's original invention, however, indicates otherwise.

Hoover's Reconstruction Finance Corporation

Contrary to popular belief, the original RFC was not a product of Franklin Roosevelt's "New Deal" but was an offspring of Herbert Hoover's administration. After over a year of intensive lobbying, Hoover signed the RFC into law on January 11, 1932. Also contrary to popular belief, the RFC was a dismal failure that most assuredly made the Depression worse. Even though tens of billions of dollars were spent, unemployment stood at 9 million in 1939 and increased

[7]See Lambro (1980) for dozens of similar examples.

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to the level reached in 1932 as the United States entered World War II.[8] This is hardly evidence of the alleged success of the RFC, and should come as no surprise, for the sole purpose of the RFC was to make unsound investments; that is, those that had been shunned by private capital markets. For this reason the RFC also severely reduced consumer welfare during the Depression years. That a private business venture is unable to obtain credit is evidence that the venture is not likely to satisfy consumer demands as well as alternative uses of that credit. Therefore, the private capital markets channel those funds into uses that would better serve consumers. Thus, the effect of the RFC was to *reduce* economic growth *and* to replace consumer demand with the preferences of politicians and bureaucrats.

The RFC could not possibly have aided economic recovery during the Depression, nor could it do so today. It only served to delay the market adjustments that are necessary to attain economic recovery. During an economic downturn, market forces work to channel resources into their most productive uses, enhancing economic growth and spurring a recovery. Subsidizing less productive resources through the aegis of the RFC only delayed or aborted the recovery.

The true character of the RFC was revealed during congressional floor debates on the RFC bill in 1931. There was little pretense that the bill was anything but a means of subsidizing economically inefficient but politically popular businesses. As historian James Olson stated (1977, p. 112):

> The response of businessmen to the bill was so overwhelmingly positive that Congressmen were immediately suspicious. Representatives of commercial banks, railroads, savings banks, building and loan associations, and life insurance companies all praised the bill in glowing terms. [T]heir commitment to the bill was absolute.

Several congressmen harshly criticized the bill. Representative Fiorello LaGuardia of New York, for example, called the bill

> a millionare's dole and you cannot get away from it. It is a subsidy for broken bankers—a subsidy for bankrupt railroads—a reward for speculation and unscrupulous bond pluggers.[9]

Representative Louis McFadden of Pennsylvania was even more critical, calling the bill a scheme by "financial criminals" for

> gouging $500,000,000 out of the Treasury of the United States. It is a scheme for taking $500,000,000 of the people's money produced by labor at a cost of toil and suffering and giving it to a supercorporation

[8]Cited in Rothbard (1972).

[9]*Congressional Record,* 11 January 1932, p. 1742.

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> for the sinister purpose of helping a gang of financial looters to cover up their tracks.[10]

As long as it was in their self-interest to do so, these and other congressmen "spoke their minds" about the RFC and what it was designed to accomplish. But attitudes changed as soon as President Hoover showed them how it could work to their own political advantage. For example, Arkansas Senator Joseph Robinson's objections were eliminated by the promise to grant loans to livestock and agricultural credit corporations, to federal land banks, and to joint stock land banks (Olson 1977, p. 38). Senator Ellision ("Cotton Ed") Smith of South Carolina became a true believer because of a promise to grant $50 million to the Secretary of Agriculture for small crop loans. Other congressmen were similarly convinced of the so-called merits of the RFC when Hoover asked *them* to select the members of the RFC's board of directors. Thus it was that a process of arm twisting and logrolling produced the RFC in January 1932, despite earlier protests. Hoover then praised the "patriotism of the men of both houses of Congress who have given proof of their devotion to the welfare of their country, irrespective of political affiliation."[11]

The RFC act provided for massive government intervention in the economy by extending loans and loan guarantees to such enterprises as banks, insurance companies, trust companies, building and loan associations, mortgage companies, credit unions, federal land banks, agricultural credit corporations, livestock credit companies, railroads, and, eventually, even topless bars and massage parlors.[12]

As with the proposals for a new RFC, the original RFC's board of directors included businessmen, bankers, and bureaucrats. It is no surprise, therefore, that big business, big banks, and government bureaucracies were the major beneficiaries of the RFC, all at the expense of the American taxpayer, who was subjected to one of the largest tax increases in history (up to that time) in 1932. The large tax increases of 1932 surely stifled private economic activity even further, thereby deepening the Depression.

Once the RFC began its operations in early 1932 it attempted to make every individual, group, and industry a "preferred borrower," as each congressman scrambled to ensure that his constituents would receive their share of the largesse. Jesse H. Jones, director of the RFC from 1932 to 1945, wrote a book boasting about how he spent

[10]*Congressional Record*, 11 January 1932, p. 1924.

[11]*Congressional Record*, 11 January 1932, p. 1705.

[12]For a history and analysis of the loans made by the original RFC, see Denzau and Hardin (1984).

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$50 billion of taxpayers' funds during that time "with almost unlimited authority" (Jones 1951, p. 3). The enormous scope of government intervention in the credit markets is revealed in the volume by Jones, and is exemplified by such statements as, "we even loaned money on a drove of reindeer in Alaska," and "when the grape growers of California felt the pinch of hard times, they, like almost everyone else, hollered for help in Washington" (1951, p. 183).

The RFC bailed out thousands of failing businesses and, by law, it was designed to do exactly that. As Jones stated, "The law specified that we should lend only where the borrower could not get the money from others on reasonable terms" (1951, p. 183). Thus, the RFC was to make only inefficient investments, those that would reduce both economic growth and consumer welfare. It was merely a tool Jones and his political allies used to forcefully impose their preferences on the general public at the great expense of intensifying the Depression. That RFC bureaucrats were among the chief beneficiaries of the RFC's operations is indicated in Appendix IV of Jones's book, "Some RFC Alumni Who Have Done Well," which reads like a "who's who" of the Fortune 500. For example, the first page of the appendix lists former RFC loan executives, auditors, and attorneys who, after they left the RFC, attained such positions as vice president of Greenwich Savings Bank, general solicitor of the Baltimore and Ohio Railroad, and various bank presidencies. For these individuals, working at the RFC was an investment in human capital, a time spent feathering the nests of banks and businesses (at taxpayers' expense) in return for future employment opportunities with those businesses. Other researchers (Eckert 1981) have found this to be a general consequence of government regulation of industry. Regardless of the "public interest" rhetoric, much regulation merely serves to benefit regulators and various regulated industries, not the general public, and the RFC was no exception. It is easy to understand why so many bankers, businessmen, union leaders, and politicians have chosen to ignore history and reality by making appeals for a new RFC.

In summary, government control of credit allocation is inherently incompatible with economic growth. The argument that if only done "right," government bureaucracies can outperform private markets is nonsense that simply should not be countenanced. Moreover, arguments that greater government involvement is essential for reasons of "fairness" or "social justice" are equally unfathomable. In a free market economy, those who make the best use of resources are those who can best serve others in the society. Those who offer consumers the best products at the lowest prices will be "targeted" by the capital markets. Politics can only obstruct this process by

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arbitrarily redirecting resources to politically popular but economically inefficient uses, and at great expense to consumers. The loss of individual freedom is heightened by this process, for individuals are encouraged to put less effort into pleasing others in the society (that is, consumers) and more toward catering to the whims of the political authorities.

Cooperation and Conflict: The Industrial Policy Delusion

A basic premise of most, if not all, of the NIP proposals is that the problem of slow economic growth is best addressed through "cooperation," most notably between "government, labor, and business," an arbitrarily chosen collection of special interests. The political process is said to embody a spirit of cooperation among businessmen, union leaders, and politicians that will help solve the nation's problems (as though nations, not individuals, have problems). However, there are two basic misconceptions here. First is the age-old myth that collective, as opposed to individual, decisions are made for the "public interest," in a spirit of selflessness or concern for others. "Good" motivation is thought to lead to "good" results. By contrast, "bad" motivation (for example, self interest and the profit motive) leads to "bad" results. In other words economic problems are often caused by perverse individual behavior, but they can be corrected by a sufficiently benevolent group of enlightened statesmen. Clearly, we do not observe this type of schizophrenic behavior: There is no logical basis for believing that individuals are any more or less self-interested when they make collective decisions than they are when making individual decisions. No divine transformation takes place when individuals leave the private sector for the public sector; nor do halos turn to horns when the opposite occurs.

This has given rise to the second major misconception, a confusion over the meaning of "cooperation" in market as opposed to nonmarket (that is, political) settings. As stated earlier, the market is essentially a process through which individuals, acting in their own interests, cooperate to get what they want, subject only to the principle of mutual agreement. Adam Smith's well-worn dictum is as trite as it is true: It is not the benevolence of the butcher or baker that provides us with our meat and our bread, but concern for their self-interest.

By contrast, *political* cooperation is inherently conflictual, for political "exchange" is necessarily zero-sum, at best. In politics, one party or coalition can gain *only at the expense of others* through a

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rearrangement of property rights. This will always be true in the absence of a voting rule of unanimity. The coercive powers of the state are used to enforce such changes, which are the source of much social conflict. Market exchange, since it is voluntary, is necessarily positive-sum or "unanimous," benefiting *all* parties involved.

Recent events in the transportation industry illustrate what can be expected from "cooperation" in politics. It is well known that in the trucking industry, for example, business, labor, and government have cooperated and the Interstate Commerce Commission was part of an earlier industrial policy aimed at fostering such cooperation. With the aid of the coercive powers of government, trucking firms and the Teamsters union were able to cartelize the trucking industry, thereby redistributing wealth from the general population to themselves. Politicians gladly cooperated, for they shared in the government-sanctioned monopoly profits in the form of votes, campaign contributions, and other means of political support. Strong taxpayer support for deregulation of the trucking industry is evidence that taxpayers do not find this particular industrial policy to be in their best interest. This, however, is precisely the type of cooperation NIP enthusiasts urge upon us.

Business, government, and unions can also be expected to cooperate on the issue of protectionism. The notion that businesses and unions are generally adversaries who deal with each other on an "arms length" basis is becoming increasingly untenable. This is so because in many areas businesses and unions cooperate or conspire to secure common objectives, such as protection from international competition. In recent years U.S. automobile producers have joined forces with the United Auto Workers to lobby for import quotas, "domestic content" legislation to require foreign cars to be constructed in the United States, and other forms of protectionism. And they have been quite successful; the Reagan administration has succumbed to protectionist pressures in the automobile, steel, textiles, motorcycle, and even clothespin industries, to name a few.

In sum, because government is the chief agent of coercion in society, it is misleading, at best, to suggest that political cooperation will lead to such lofty goals as "economic progress" or "social justice." A coalition of business, labor, and government is more likely to conspire against the general public than cooperate to serve it. In contrast, since free trade is voluntary, no individual or group can coerce or exploit another in market exchange. It is in every individual's self-interest to cooperate with others (most of whom he does not know) by trying to produce what they want. By doing so the welfare of society as a whole is enhanced. If one wishes to stress the

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importance of cooperation in economic affairs, the appropriate emphasis should be on *market* exchange or cooperation, not political cooperation. The former tends to increase the wealth of nations, whereas the latter is a major source of economic stagnation.

The Industrial Policy Cycle

In essence the NIP proposals are nothing other than a thinly disguised plea for an expanded welfare state and some version of national economic planning. It is sufficiently clear, however, that these policies are the root causes of economic stagnation. In recent decades government intervention has severely stifled productivity in the United States and elsewhere largely because of accelerated inflation, high taxes (and tax rates), price controls, and other regulations (Kendrick 1981). All of these government policies stifle individual incentives to work, save, and invest, which are the ingredients of economic growth. These policies also increase the power and prestige of politicians, bureaucrats, and other supporters of the welfare state and governmental planning. This is why, despite overwhelming evidence accumulated ever since Adam Smith exposed the fallacies of mercantilism, there are renewed pleas for even greater government intervention. When NIP proponents simply ignore all the lessons of history and economic theory, they participate in a con game that must be exposed.

It has often been said that in government, "failure is success." That is, when government policies cause economic instability there is inevitably a public demand for the government to "do something" about it. It is the natural proclivity of politicians to avoid admitting that their own actions caused the problems in the first place and to undo their mistakes. Instead, they typically offer new programs and policies to "solve" the problems. The end result is even more economic instability, and even greater power placed in the hands of the political authorities. The current industrial policy hype is part of this cycle and is largely a political response to the failed governmental policies of the 1960s and 1970s.

NIP proponents have distorted the facts about the U.S. economy. Government intervention is clearly the cause of, not the cure for, our economic problems. NIP enthusiasts have also reversed reality when they cite the Japanese economy as a successful prototype of their brand of industrial policy. If one considers the *facts*, the Japanese experience provides an invaluable lesson for the United States and the rest of the world, but the lesion is not that an interventionist industrial policy works. Dr. Katsuro Sakoh (1983) conducted an

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extensive empirical study of the relatively prosperous Japanese economy of the early 1970s and concluded that Japan's success was the result of

> [a] basically free market economy, functioning effectively with minimal government intervention. The collapse of Japan's traditional feudal society in the 1940s and the emergence of a more open society triggered an explosion of creative energy. Free speech, human rights, and freedom of investment and pricing changed the country's political and economic dynamics. Any Japanese—regardless of age, class, or family background—could venture into business and succeed through hard work, imagination, willingness to take risks, and luck. Many dynamic and exciting new enterprises, such as Honda, Yamaha, Sony, and Suzuki, to name but a few, sprouted in this climate. In short, individual entrepreneurs did not invest in capital goods and equipment because MITI officials suggested it, but because these entrepreneurs glimpsed the potential for future profits by beating the competition in both domestic and foreign markets. The market mechanism allowed Japan's industrial structure to be transformed by the 1970s, as older industries were replaced by these new manufacturing industries.

The "Japanese miracle" has now apparently ended, as the Japanese economy became very sluggish beginning in the mid–1970s. It is no surprise that as this occurred, there was a marked increase in government intervention. In 1982 Japan experienced its first large quarterly drop in real GNP in 30 years, and economic growth during that year was only about a third of what it had been during the previous 25 years (Drucker 1982, p. 28). Furthermore, productivity growth has fallen even more steeply in Japan in recent years than in either the United States or Western Europe, and savings are only two-thirds of the average levels of the 1970s. The reasons for this little-publicized economic decline are not that Japan has abandoned what little efforts it had made at "industrial policy," but rather the familiar problems of uncontrolled government spending and rising federal deficits and regulation. As Drucker recently stated (1982, p. 28):

> Throughout its years of rapid economic growth, from the early 1950s to the mid 1970s, Japan's budget was balanced or in slight surplus. Japan shifted to deficit spending in 1975–76 and the economy promptly began to slow down. The deficit is now more than three times larger than seven years ago. It is larger, both per capita and as a proportion of GNP, than the deficit of any other highly industrialized country except Canada. And, just as in the highly developed countries of the West, government in Japan is now beginning

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> to crowd private borrowers out of the capital markets. This is occurring just when Japan needs to make heavy investments in automation, in new technologies and in manufacturing subsidiaries abroad. . . .

The question that must be posed to those who advocate an interventionist industrial policy for the United States is: If such a policy is responsible for Japan's success, why has the Japanese economy stagnated during the past eight years (in many ways far more severely than the economies of either the United States and Western Europe)?

Conclusion

One positive aspect of the industrial policy debate is that it has refocused attention on the important issue of the role of government in a free society. One role of government is to protect private property, freedom of exchange, and freedom of contract. In short, the government's responsibility is to cultivate an institutional environment in which the spontaneous forces of the market can best coordinate individual plans so as to enhance individual welfare. Government, however, has strayed far from this role, and it now actively supersedes the forces of the market and is, therefore, the cause of many of our economic problems. Furthermore, the redistributive role of government is a major source of interpersonal conflict, despite the much-touted pleas for greater "cooperation" among politicians, businessmen, and union leaders. The industrial policy proposals would empower the government to expand its activities of favoring some groups at the expense of others in society, which violates the principles of justice and equality of treatment—principles that NIP proponents ironically claim to be their concern. Neomercantilism is perhaps a better name for an interventionist industrial policy. Adam Smith described what he thought was the immorality of such policies more than 200 years ago (1960, p. 152):

> To hurt in any degree the interest of any one order of citizens, for no other purpose but to promote that of some other, it is evidently contrary to that justice and equality of treatment which the sovereign owes to all the different orders of his subjects.

To invigorate industry and to pursue the principles of justice and equality of treatment requires reducing the size and scope of government, not expanding it. Accordingly, an appropriate industrial policy is one that reduces the burden of taxation, encourages privatization of government-run enterprises, eliminates regulatory restrictions on the freedom of exchange, and places strict limitations, perhaps

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constitutionally imposed, on the size and growth of government and on the destruction of wealth and welfare it inevitably entails.

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BREAKING THE BARRIERS TO U.S. ECONOMIC GROWTH

John M. Albertine

Introduction

We all know what a popular buzzword "industrial policy" has become in Washington these days. The trouble seems to be that the term "industrial policy" means different things to different people. To me it means a set of generic policies that break barriers to economic growth. To some liberal Democrats industrial policy means extensive, intrusive government planning and targeting.

The truth of the matter is that industrial policy is not a new idea. We have had an implicit industrial policy in the guise of an informal set of tax, economic, and regulatory guidelines since World War II. The problem is that our industrial policy has not been very good. In fact, more often than not, it has been totally irrational. There have been tremendous weaknesses in the ways in which our tax laws, regulatory policies, and economic programs have interacted. They have conspired to give us an industrial policy that has thwarted growth more often than it has encouraged it.

The Wrong Approach to Industrial Policy

Some believe that we should take an interventionist approach to industrial policy. They believe that the government should pick prospective winner industries in our economy and coddle them until they boom. I am completely opposed to this strategy, because I think it takes a naive view of how the political process works in America today.

First, it would be impossible to depoliticize the process of picking the winners. No matter what saints were hired to make the decisions,

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politics would eventually come into play. Some claim that no one would ever try to politicize something as important as our national industrial policy—just as no one has ever tried to siphon our defense dollars for pork-barrel projects.

Second, the government cannot make a decision quickly. The federal government does not do anything quickly. It cannot even deliver the mail quickly. The venture capital market can make decisions much more rapidly.

Third, however well-intentioned, the government is wrong quite often. When venture capitalists are wrong, they cut their losses and move on. When government officials make mistakes, their errors go undiscovered for a long time, because no one wants to take the blame. Everyone involved claims that it is not really a mistake after all. Then Congress holds hearings. About the time that the executive and legislative branches finally agree, the lawsuits start.

We are the world's most litigious society. If the government had been picking winners for the last century, the appeals of the buggy whip manufacturers would still be before the Supreme Court.

Rather than an interventionist industrial policy, I think we would be much better off with one which allows the market to make most of the decisions. If we look at the roots of our economic ills, I think it will be easy to see why this approach would offer the correct cure.

Our Major Economic Problem: Poor Productivity Performance

Sluggish productivity growth was the cause of the malaise which descended upon our economy in the early 1970s. Weak productivity led to high inflation; it eroded real incomes; it increased unemployment; it weakened our trade balance; it depressed our standard of living.

According to a recent study by the Joint Economic Committee (U.S. Congress 1980), the capital/labor ratio is the key explanatory variable in the productivity equation. The index of the capital/labor ratio declined steadily throughout the 1970s. Our poor productivity performance during the last decade can be attributed to the confluence of demographic changes that increased the labor force and tax policies that discouraged capital formation.

A record number of people, about 22 million, entered the labor force in the 1970s. This expansion in the labor force was a result of the postwar baby boom and the more active role of working women. However, the rate of growth of capital formation did not keep pace

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with the growth in the labor force. Indeed, in the 1970s, the United States invested a smaller percentage of its GNP than did its major trading partners. As a result, U.S. workers, on average, had less capital at their disposal. The demographic changes are unlikely to recur, but the capital formation problem continues. The reasons for the capital insufficiency are complex, but tax policy is one of the main culprits.

Before 1981 the congressional tax writing committees focused on achieving "tax equity," and "tax equity" meant tax policies that sought to equalize the after-tax incomes of all Americans by redistributing income. This philosophy produced a tax system with high marginal rates and an inherent bias against savings and investment. Income produced by thrift and risk-taking was labeled "unearned" and taxed at essentially confiscatory rates. Pre-1981 tax policy favored consumption at the expense of savings and investment, and it was a key component of the irrational industrial policy of the postwar era.

The ERTA Experience

Once low productivity was recognized as the underlying cause of our economic distress, economic policy did an about-face. In 1981 tax policies were changed to spur investment, particularly in the large, capital-intensive industries (such as autos, steel, and heavy manufacturing) which had dominated the American economy in the first half of the 20th century. The penalties for savings and investment were finally reduced, however slightly.

The Economic Recovery Tax Act (ERTA) of 1981 favored general capital formation. A consensus among policymakers made the liberalization and simplification of depreciation the top priority. However, depreciation reform was viewed as insufficient. The large, capital-intensive industries in declining sectors of the economy still had large constituencies in Washington. Hence the right to sell tax credits was given to firms not profitable enough to take full advantage of the new tax breaks.

Despite all the hoopla over ERTA, it turned out to have very little impact, because the high-inflation, low-productivity economic policies of the 1970s finally caught up with us. ERTA precipitated a comparatively small drop of only 1.2 percentage points in the total cost of capital services for corporations. Interest rates soared and completely swamped the effects of ERTA. This led some to conclude, incorrectly, that increasing incentives was insufficient, and large-scale intervention would be necessary to stimulate investment.

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To Stimulate Investment, Lower the Cost of Capital

There is plenty that the government can do to raise productivity and increase our competitiveness without large-scale government intervention. Lowering the high cost of capital is on the top of my list, because this would spark greater investment. The American Business Conference is working on a study of the need to lower the cost of capital in this country. One of the members of the ABC, Dr. George Hatsopoulos, chairman of the Thermo Electron Corporation, is supervising the study, and he has employed some of the best young economists in this country to assist him. The recent findings show that the cost of capital in the United States is about triple the cost of capital in Japan (Hatsopoulos 1983).

Our study shows that high U.S capital costs have precipitated the deterioration in the competitiveness of U.S. firms in world markets. For example a car containing $10,000 of U.S. labor and capital would cost only $4,900 in Japan. The lower marginal cost of capital in Japan accounts for $2,300 of the cost savings in Japan.

The cost-of-capital differential between our country and Japan has important implications for the development of the high-technology sector, the sector upon which so many are pinning their hopes for an Amercian economic resurgence. The Hatsopoulos study shows that for a project requiring five years of development and having the same probability of success in the United States as in Japan, the enormous disparity in the cost of capital would mean that Japan could invest two and a half times as much as would be justifiable in the United States. For a project requiring 10 years of development, Japanese businessmen would be able to justify spending five times as much as Americans, solely on the basis of their lower capital costs.

Americans are very smart and innovative, but we are not five times as smart and innovative as the Japanese. Since the Japanese will be able to undertake much more research and development, they may well be able to outstrip our much-heralded high-tech sector.

The structure of our tax code is one of the key factors contributing to higher capital costs in this country. The differential in capital costs is not simply the result of the numerous Japanese incentives for savings. U.S. financial regulations, the Glass-Steagall Act, and standard U.S. management practices encourage U.S. firms to seek equity financing. Most U.S. corporations have a debt-to-equity ratio of 1 to 3, while it is 3 to 1 for most Japanese firms. Since the return on equity is taxed twice in this country—at the corporate level and at the personal level—U.S. firms must offer a much higher pre-tax rate of return in order to offer a competitive after-tax return. The

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combination of an institutional/regulatory preference for equity and the tax treatment of equity puts U.S. firms at a real disadvantage.

The ABC is currently looking at a number of ways in which the cost of capital can be lowered. One of the mechanisms that we are studying right now is to allow deductibility of dividends on new equity issues.

Another is a further reduction or elimination of capital gains taxes on investments in equities. In a corporate world that is dependent on equity financing, the level of the stock market is a key determinant of the cost of capital. The stock market boom of the early 1980s did more to lower the cost of capital than did the drop in interest rates or the 1981 legislation liberalizing depreciation.

There is considerable evidence that the 1978 reduction in capital gains taxes helped to foster the advance in stock prices and, as a result, lowered the cost of capital for American business. In fact I think the reduction in capital gains taxes was the single most important economic policy undertaking of the 1970s. It was a brave and creative step, because it broke barriers to U.S. economic growth.

More-Efficient Investment

The quantity of investment is not the only issue—the quality is important too. The United States not only underinvested in the 1970s, it got less bang from its investment buck. While liberalized depreciation should raise capital investment in the long run, it will not address the declining efficiency of investment. In a time of budget crisis, when tax incentives are increasingly hard to justify, we must make sure that our policies will deliver the greatest productivity enhancement possible for each dollar of tax incentive.

The New York Stock Exchange's Office of Economic Research (1979) has developed a measure of the effectiveness of investment called the investment efficiency ratio (IER). It measures how much real growth the economy produces for each dollar of real nonresidential investment. The higher the real growth produced by each investment dollar, the higher the IER for the economy. During the 1950s the IER averaged 30.2 percent; in the 1960s it declined slightly to 27.1 percent; but in the 1970s the IER dropped dramatically to 12.8 percent.

While part of the solution to our productivity problems will come through a generic decline in the cost of capital for all American firms, we must encourage the allocation of resources to those firms and industries which will use them most efficiently. We must facilitate the expansion of the firms of the future, rather than propping up

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declining industries. One of the ways of doing this is to eliminate (or, at least, reduce) the biased and inefficient corporate income tax.

The Corporate Income Tax: A Case of Inefficient Economic Policy

Few tools of economic policy skew the allocation of resources as much as the perversion known as the corporate income tax. It is a tax on production, and it causes nonoptimal allocations of our scarce resources. It may be the biggest barrier to economic growth in our country. Moreover the corporate income tax is one of the least efficient ways of raising revenue. Sooner or later the corporate income tax should be abolished.

First of all, the corporate income tax is not paid by corporations. It is paid by consumers, shareholders, and workers:

- It is shifted forward to consumers in the form of higher prices.
- It is shifted backward to stockholders in the form of reduced dividends.
- It is shifted backward to stockholders in the form of lower retained earnings and the consequent lower net worth of corporations.
- It is shifted backward to workers in the form of lower wages.

What this means is that consumers, stockholders, and workers are paying a hidden tax. Some labor unions support higher corporate taxes and are unaware that it is their members who will actually pay the additional tax. There is a total lack of accountability for the burden of the corporate tax, and that is why politicians are so enamored of raising corporate taxes.

There is a second reason why the corporate income tax is poor economic policy. The consensus of tax economists is that most of the corporate tax is shifted backward—it is a tax on labor and capital. As such it is really a tax on production and slows the growth of American industry. The corporate income tax makes our most distressing economic problems—expensive capital and low productivity—much worse. It is a real roadblock to economic growth. The burden of the corporate tax should be shifted away from workers and investors, because they are what this economy needs most of all.

The third fault with the corporate tax is that it is not symmetrical. All firms do not pay the same rate. Large, established, capital-intensive firms generally pay much lower tax rates than smaller, rapidly growing companies. The American Business Conference—a coalition of 100 firms that have annual revenues between $25 million and $1 billion and that have doubled in size over the last five

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years—studied this issue (Cavanagh and Clifford 1982). They found that the highly successful ABC companies paid effective tax rates that were nearly double those of the Fortune 100.

The "Pease-Dorgan Study," recently completed by the Joint Committee on Taxation (U.S. Congress 1983), confirmed the wide variations in effective tax rates. The trucking industry paid effective rates averaging about 40 percent over the 1980–82 period, while the chemical industry paid only 4.3 percent. The computer industry paid almost 26 percent, while the paper industry enjoyed negative effective tax rates.

This lack of symmetry causes a misallocation of resources. If you could make a $10,000 investment that would have the same pre-tax payoff in either computers or paper, the tax code would force you to put your money in paper. The existence of the corporate tax thwarts the efficient allocation of resources. It skews resources away from high-tax industries—often new, rapidly growing entrepreneurial sectors—and toward low-tax industries—frequently older, declining sectors with high-priced lobbyists. Our resources would be allocated much more efficiently, and our nation's output would be higher in the absence of a corporate income tax.

Proposals to impose a corporate surtax would only exacerbate the asymmetry problems associated with the corporate tax. A surtax would render the allocation of America's resources less efficient. A corporate surtax looks good on paper, because it is a hidden tax and appears to be an equitable tax. However, because of the wide differential in effective tax rates, it is a very inequitable tax. Those already paying the highest tax rates would pay the most. Those paying the lowest rates would pay the least. Since it would result in further misallocation of our resources, it would certainly not be consistent with long-term economic growth.

Good economic policy strives to increase national output and make our economy more competitive. This means that we should try to reduce marginal corporate rates in order to eliminate the biases in effective corporate rates. We should work toward the overall abolition of the corporate income tax and replace the lost revenue with taxes which do not penalize savings and investment. We must turn away from taxes which penalize production and thwart savings and investment, and turn toward generic policies which offer incentives for production, thrift, risk taking, and investment.

Tax Reform Is Not Enough

A generic industrial policy that includes tax policy changes which lower the cost of capital and reduce marginal corporate tax rates will

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increase economic efficiency and have a high productivity payoff. Yet our implicit industrial policy extends far beyond our tax code. We should examine our regulatory apparatus and export-promotion programs to see how they affect high-growth entrepreneurial firms. We must try to remove all the roadblocks to economic growth.

This means procedural regulatory reform, not just reform of individual statutes like the Clean Air Act. There is irrefutable evidence that entrepreneurs are methodically overwhelmed by the complexity of federal and state regulatory programs. Revision of individual statutes will not have much impact, even at the margin.

One positive step in the process of formulating an efficient industrial policy was the passage of the Export Trading Company (ETC) Act in 1982. Programs like the ETC assist high-efficiency investors. They are entrepreneur oriented.

Conclusion

Our tax code and regulatory apparatus create an implicit, de facto industrial policy regardless of whether the Congress or the administration desires one. In this time of budgetary cutbacks, our limited resources must be used as efficiently as possible. While there will inevitably be transitional disruptions in the short term, it is time to change the focus of our industrial policy from shoring up our declining industries to stimulating entrepreneurship and the efficient flow of resources within our economy.

Our industrial policy must favor efficient, productivity-enhancing investment. We can no longer afford the productivity losses associated with the anti-investment industrial policy of the 1970s nor the slow recovery in productivity will result from the general investment policies of 1981. The market works, and with the policies that I have outlined here, we can allow it to work even better. The engine of American economic growth does not need a complete overhaul. It just needs a little more free-market oil.

The interventionist industrial policies advanced by liberal economists and aspiring philosophers sound great on paper, but they will not work in practice. If the government had begun picking winners when interventionist industrial policies were first discussed, our children would probably still be playing with hula hoops, instead of computers. What we should do is adopt generic industrial policies that systematically remove roadblocks to economic growth.

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A PRO-MARKET NATIONAL INDUSTRIAL POLICY

Richard B. McKenzie

The small but highly visible group of economists and industrialists who are pressing for the United States to establish a national industrial policy have colorfully but inaccurately painted a picture of a U.S. industrial economy in decline. Harvard University Professor Robert Reich, one of the gurus of the new mythology, warns that the economic system is so fettered with special privileges for politically powerful business interests that it will continue to unravel during the 1980s unless government intervenes to help business "adapt" to new competitive pressures (Reich 1983, p. 3). And, of course, his own menu of industrial policies is just the solution needed to get things going again. Boston College Professor Barry Bluestone and MIT Professor Bennett Harrison bemoan the tens of millions of jobs destroyed over the past decade by a capitalistic system they view as more concerned with profits for owners than the human welfare of workers and consumers (Bluestone and Harrison 1982). They, too, know that with their direction the government will be able to fix things.

Senator Gary Hart is more philosophical. He maintains that conventional government policies of the past have become "increasingly irrelevant to the unique economic realities of the decade." Such a predicament can only be relieved, Hart attests, by "melding" the "Jeffersonian principle of free competitive economy" with the "Rooseveltian principle that economic success cannot be divorced from social conscience" (Hart 1982, p. 4).

The path to economic salvation, Bluestone, Harrison, Reich, Hart, and the others believe, is paved with greater government intrusion in the economy: more government expenditures for a wide variety of social services, more government protection from competition,

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and bailouts for businesses. In effect they recommend a time-tested problem as the solution. John Albertine's (1984) assessment of the country's economic problem is welcomed for its accuracy and because it points the way to realistic and viable, politically plausible solutions.

The national industrial policy lobbyists, however good their arguments may sound, are selling snake oil. Even Brookings Institution senior fellow Charles Schultze, advisor to Democratic presidents, has concluded (1983, p. 4): "America has not been deindustrializing. Throughout the industrial world, economic performance in the 1970s did fall behind the records of the 1960s. But relative to the industries of other countries, American industry performed quite well by almost all standards." A recent study by George Mason University economist Thomas DiLorenzo illustrates this clearly. He points out that in the 1950–81 period manufacturing output in real terms stayed in the range of a quarter of GNP, except during recessions (1984, p. 3).

The goals of the national industrial policy proponents—to save and create jobs—are admirable. In fact they are commonly shared by proponents and opponents alike. However, the proposed remedies are bound to do more harm than good:

- Proposed increases in government expenditures for a wide variety of social welfare services will add to the ballooning $200 billion federal deficits. Many economic analysts are convinced this could crowd out private investment—and jeopardize and destroy jobs in the private sector.
- Proposed business bailouts with subsidies and loan guarantees from a reconstructed Reconstruction Finance Corporation will serve only to impose greater tax and interest burdens on firms that have kept their costs, including wages, competitive for the benefit of mismanaged, noncompetitive, but politically powerful established firms in need of government aid.
- Proposed protection from foreign competition by way of "domestic content bills" and/or higher tariff and quota walls will raise the prices American consumers must pay for their goods and reduce the real incomes of Americans. At the same time, because of the inevitable two-way nature of international trade, protection that obstructs imports will also lower exports and jeopardize the jobs of the five million workers in the country's export industry.
- Proposed "tripartite councils," designed to establish national economic goals and chart central plans for the country, will "collectivize," "politicize," and "bureaucratize" economic decisions in the country and, to that extent, will cramp the ability of American firms to adapt and compete on international markets.

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As Schultze (1983, pp. 10–11) has stressed, "[I]t is a curious logic to cite examples of how the American industrial structure has been distorted by political pressures in support of an argument for entrusting even more economic decisions to the same political process."

Few deny, however, that continued changes in federal policy are needed to spur long-term economic growth. Dr. Albertine has suggested a number of important policy changes. He proposes, in effect, an alternative set of industrial policy recommendations that place more, not less, reliance on market processes. My only comment is more needs to be done. *The Blueprint for Jobs and Industrial Growth,* which I edited for the Heritage Foundation (1984), spells out an alternative industrial policy. That program is founded on a limited number of several guiding premises that can be outlined as follows.

First, long-run growth in private industry requires reducing federal deficits to tolerable levels and stabilizing monetary growth. Congress, especially, must curb its spending, or be disciplined by balanced budget/spending limitations.

Second, antitrust policies must not continue to be "anticompetitive" policies. Hence the focus of enforcement policy must be shifted to artificial barriers to entry and away from firm size and industry concentration, which often are the consequence of highly competitive market processes and present no threat to competition. The "rule of reason," which effectively abolishes the automatic trebling of damages in antitrust cases (except in overt cases of monopoly practices), must be institutionalized to reduce attempts by businesses to obstruct competition through nuisance suits—the central purpose of which is often to force firms to agree to lucrative out-of-court settlements rather than spending years of valuable time and millions of dollars defending themselves in court. State and municipal organized and condoned monopolies should be no more exempt from antitrust law than any other privately inspired cartel. All monopolies should be subject to the same legal constraints.

Third, social and environmental regulations must be reevaluated to ensure that undue costs are not being imposed on American producers. Specifically, cost-benefit analysis must figure more prominently in regulatory decisions, especially in the development of performance standards that should be more widely used in lieu of engineering standards; and current and wasteful conflicts among regulatory policies in government agencies must be reconciled by a coordinating agency. The deregulation of the transportation industry should be completed with the elimination of all remaining government-inspired entry and pricing restrictions.

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Fourth, international competition mandates that we employ every means available to achieve all regulatory standards in the most cost-effective way. This means we should expand the use of the "bubble concept" in pollution control, providing industry with a more creative method for reducing air pollution. It also means we should give firms greater flexibility in selling their "emission standards," a market process that permits enhanced environmental quality at lower firm cost. Finally, it implies that the emerging "water crisis" must be averted in part by the assignment of property rights to water, a policy that will result in greater water conservation, a reallocation of the country's water supplies to higher-valued uses, and greater national output at lower cost in money and water terms.

Fifth, policies must be altered to encourage saving and capital formation. As Albertine argues, this requires lowering the double taxation of savings and capital by exempting a larger proportion of personal and business savings from taxation, lowering the corporate income tax, and reducing immediately (and eventually removing) capital gains taxation (bringing our tax system more in line with the Japanese system). It means also that we recognize that depreciation schedules for capital assets discriminate arbitrarily against fast-growing, especially high-tech, industries in which capital obsolescence is accelerating. We must move toward "immediate expensing" of all capital purchases.

Sixth, a reinvigorated growth-oriented economy requires that savings be allocated to their highest-valued use. This can be accomplished in part by amending the Glass-Steagall Act to allow, once again, banks to act as investment bankers and the McFadden Act to permit interstate branch banking. We must also replace the Federal Deposit Insurance Corporation with a system of private deposit insurance that will encourage rational, price-constrained, risk taking on the part of banks. The deregulation of the services provided by U.S. financial institutions must be completed to enhance the returns to savers, which will foster greater saving.

Seventh, labor policies must be revamped to ensure that government is not creating and prolonging unemployment. This objective can be partially met by replacing the federal supplemental unemployment compensation program (which induces extended unemployment) with a program of unemployment loans; by adjusting unemployment insurance rates to more accurately reflect the unemployment experience of firms (and thereby reducing the subsidy going to firms that create the unemployment problem); by freezing the minimum wage for adults and setting a "subminimum wage" for

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teenagers; and by repealing or modifying laws, such as the Davis-Bacon Act, that reduce employment opportunities by artificially hiking the costs of federal projects. In addition more cooperative labor-management working environments can be encouraged by once again allowing "company unions" to compete in union elections supervised by the National Labor Relations Board. And competitive labor markets can be encouraged by amending the Hobbs Act to ensure that labor violence that obstructs interstate commerce is, once and for all, a federal crime.

Eighth, economic development is critically dependent upon improvement in the public education system that, in turn, is dependent upon breaking the public school monopoly. Serious reform requires meaningful parental choice must be reintroduced into the education system by way of education vouchers and tax credits for private school expenses.

Finally, let us agree that federal programs that require more federal expenditures and are designed to save and create jobs must be evaluated fully and carefully by Congress. This means that legislation designed to subsidize and protect American firms must be accompanied by "economic impact statements" that provide (1) estimates of the number of jobs saved and created in identified industries by the expenditures; (2) estimates of the number of jobs jeopardized or destroyed in identified industries by the financing requirements; and (3) a rationale for the government destroying the jobs of some workers for the benefit of others.

There are many things the federal government can do to accomplish the objectives of the industrial policy advocates without extending the meddling arm of government in the economy. Dr. Albertine has provided a list that has been extended here. The government should take these steps as soon as possible and set aside the national industrial policies proposed by industrial policy advocates who contine to set up their soapboxes along the presidential campaign trail.

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IS INDUSTRIAL INNOVATION DESTROYING JOBS?

Bruce Bartlett

One of the principal motivations for the establishment of an industrial policy in the United States is to counteract or facilitate structural change in the economy, especially in labor markets. It is alleged that our basic manufacturing sector is in a state of semipermanent decline.[1] It is further alleged that the number of high-technology jobs is not growing fast enough to absorb those being laid off in the heavy manufacturing sector.[2] The result, therefore, will be rising unemployment and declining standards of living for many Americans.[3]

This is a pretty dismal scenario and, if it were true, might provide some rationale for the establishment of an industrial policy or some other government economic planning mechanism. I believe, however, that such fears about the future can be dispelled on both theoretical and empirical grounds. The first part of this paper will examine the theory of technological unemployment and survey the literature on this subject. The second part will look at some of the data.

The Theory of Technological Unemployment

Technological unemployment has been discussed by economists and feared by workers ever since the beginning of the Industrial Revolution in the 18th century. The issue is broader, however, than just the question of whether men are going to be replaced by machines. It really has to do with the question of what will result from any

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[1]See, for example, Eckstein et al. (1984), Bluestone and Harrison (1982), and many other current studies favoring industrial policy.

[2]See Schwartz and Neikirk (1983), Appelbaum (1983), Serrin (1983), Riche et al. (1983), McGahey (1983), and U.S. General Accounting Office (1982).

[3]In addition to the above, see Kuttner (1983), Thurow (1984), AFL-CIO (1984), and Harrington (1984).

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factor which increases output per unit of labor. Structural unemployment could result not only from automation or robotics but also from the introduction of any sort of machinery or fixed capital in the manufacturing process, or even from managerial innovation.

Although he was talking about the division of labor rather than the effects of machinery, Adam Smith made the essential point in his famous discussion of the pinmakers. In Smith's anecdote, a group of pinmakers, working separately, were barely able to manufacture one pin per day per man. However, when a group of ten got together and began to specialize—one drawing out the wire, another straightening it, a third cutting it, a fourth sharpening it, and so on—they were able to increase their collective output some 4,800 times. Instead of producing 10 pins per day between them, they could now, through the division of labor, produce 48,000 (Smith 1937, pp. 4–5). The question that immediately arises, of course, is whether this vast increase in pinmaking productivity then led to permanent unemployment in the pinmaking industry. After all, these ten pinmakers working together could now probably satisfy most of the existing world demand for pins by themselves!

Smith does not tell us what happened, but we can surmise that given the previous low productivity of pinmaking, pins must have been extraordinarily expensive, costing the equivalent of one day's wages per pin. Under the circumstances, obviously, uses for pins must have been quite limited, a luxury only for the very wealthy. However, after a 4,800-fold increase in productivity, the cost of pins would now, presumably, be just 1/48,000th of their previous cost. If the price of pins were to fall accordingly, there would, no doubt, be many new customers. New demand for pins may, indeed, rise more than 4,800 times, creating new jobs in the pinmaking industry rather than unemployment.

But what if this did not occur, and the pinmakers chose to lower prices just enough to put all the other pinmakers out of business but not enough to stimulate demand for pins substantially, thus creating unemployment and pocketing monopoly profits? Might society not be worse off somehow? Smith did not think so. He believed that the increased profits would have to be spent on something and would simply create new employment in other industries (p. 272). He also thought that competition would inevitably force prices down (p. 706). Thus he concluded that any measure which raises output per unit of input invariably makes society better off.

David Ricardo muddied the water when, in the third edition of his *Principles of Political Economy and Taxation,* he added a chapter on the effects of machinery on workers (See Hollander 1971). In this

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chapter he argued, contrary to Smith, that workers are not always better off as a group from rising productivity:

> Ever since I first turned my attention to questions of political economy, I have been of the opinion that such an application of machinery to any branch of production as should have the effect of saving labour was a general good, accompanied only with that portion of inconvenience which in most cases attends the removal of capital and labour from one employment to another.
>
> [Ricardo 1911, p. 263]

Ricardo originally felt that lower prices would free income for expenditure on other commodities, increasing demand for them, while benefiting workers who could now buy more with the same wages. Thus, after some temporary transition, all classes would benefit equally from rising productivity.

But then he changed his mind and came to believe that "the substitution of machinery for human labour is often very injurious to the interests of the class of labourers" (p. 264). He based this on a belief that the introduction of machinery (or fixed capital) would reduce labor's share of total income while raising the share going to capital. If this argument is carried to its logical extreme, workers could become poorer and poorer even as output continually increased.

The first to respond to Ricardo's argument was the French economist Jean Baptiste Say, who argued that machinery does not compete with labor at all. In Say's view, machinery merely augments the productivity of labor. To the extent that more output is created with fewer inputs, society is necessarily better off:

> A new machine supplants a portion of human labour, but does not diminish the amount of product; if it did, it would be absurd to adopt it. When water-carriers are relieved in the supply of a city by any kind of hydraulic engine, the inhabitants are equally well supplied with water. The revenue of the district is at least as great, but it takes a different direction. That of the water-carriers is reduced, while that of the mechanists and capitalists, who furnish the funds, is increased. But, if the inferior charges of its production lower its exchange-value, the revenue of the consumers is benefited; for to them every saving of expenditure is so much gain.
>
> [Say 1834, pp. 90–91]

Say recognized that there was still the problem of what to do with the unemployed water carriers. But he believed that three factors would substantially mitigate the harmful effects of such unemployment:

1. New machines are slowly constructed and still more slowly brought into use, giving those who are affected time to adjust.

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2. Machines cannot be constructed without the input of considerable labor, which can create employment for some workers even as machines may put others out of work.
3. The condition of consumers, including workers affected by the machinery, is improved by the lower prices of consumer goods.

Marx (1977, p. 568n) referred to Say's argument as "insipid nonsense," and went on basically to repeat Ricardo's argument—Marx merely added details in the form of historical data and refutations of the views of other economists, such as McCulloch, who endorsed Say's position (Schumpeter 1954, p. 685; Tucker 1961, pp. 252–69).

The vast majority of economists, however, tended to be optimistic rather than pessimistic about the effects of machinery on labor. Alfred Marshall's view may be taken as representative when he said that an increase in capital

> may occasionally diminish the field of employment for manual labor in a few trades, yet on the whole it will very much increase the demand for manual labor and all other agents of production. For it will much increase the national dividend, which is the common source of the demand for all; and since by its increased competition for employment it will have forced down the rate of interest, therefore the joint product of a dose of capital and labor will now be divided more in favor of labor than before. This new demand for labor will partly take the form of the opening-out of new undertakings which hitherto could not have paid their way; while a new demand will come from the makers of new and more expensive machinery. [Marshall 1920, pp. 553–54]

The Great Depression

The onset of the Great Depression in 1929 reopened the whole debate on structural unemployment. With the exception of Alvin Hansen (1931; 1932), most economists tended to dismiss the idea that vast amounts of unemployment were the result of technological change.[4] They tended to concentrate, correctly, on the relation of aggregate demand to the government's monetary and fiscal policies. Perhaps typical was the view of Professor Willford King, who said in 1933 (p. 390):

> There is nothing in the statistical evidence now available to indicate that new inventions are not still continuing to benefit labor. It is absurd to blame technological improvements in methods of production for the evils resulting from our antiquated and unsound monetary system. Because of imperfections in this system, the prices of most products of industry have been allowed to decline sharply.

[4]See Gregory (1930), Haberler (1932), Kahler (1935), Fisher (1937), and Dankert (1940).

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> The obvious result is that employers can no longer hire the total labor force of the nation at the old wage rates. To adjust wage rates to lower levels is, however, a slow and difficult process. Unless the prices of the products of industry rise, unemployment is likely to continue until wages are adjusted downward to an extent approximately equal to the fall in the price level. . . . The present situation may be summed up by saying that no facts or figures thus far discovered cast any doubt upon the approximate validity of the orthodox economic theory that the forces giving rise to technological unemployment tend, at the same time, to create a demand for new goods, and that the production of these new goods normally calls for a volume of labor roughly equalling the quantity displaced.

John Maynard Keynes himself accepted the view that technological unemployment was temporary and that technological innovation was good for society (1963, pp. 358–73). Nevertheless people remained concerned about the issue of technological unemployment—politicians in particular. The Works Progress Administration, for example, commissioned economist Alexander Gourvitch (1966) to thoroughly survey all existing literature on the subject of technological change and employment. The literature was generally sympathetic to the Ricardo-Marx view. The Temporary National Economic Committee (1940) also delved into the issue thoroughly, holding many days of hearings on the relationship between technology and the economy, and it commissioned a lengthy study on the subject in 1941. Again the thrust of this work tended to support a pessimistic view of the impact of technology on unemployment.

The onset of World War II ultimately solved the unemployment problem, and concern about technological unemployment quickly faded away. The slow growth of the mid-1950s, however, combined with what seemed to be a quickening pace of technological innovation—especially the development of the computer—again gave rise to concerns that permanent unemployment may result from what came to be called automation.

The Automation Scare

The automation scare of the late 1950s appears to have started from a series of hearings held in 1955 by the Joint Economic Committee of Congress, which issued a report on *Automation and Technological Change* in January 1956. The committee concluded that "no specific broad-gage economic legislation appears to be called for" since the Employment Act of 1946 was already on the books (U.S. Congress 1956b, p. 13). Nevertheless it suggested that the federal government more closely monitor the effects of advancing technology and productivity on employment.

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However, rising unemployment continued to fuel interest in the automation issue. Although low by today's standards, unemployment more than doubled between 1953 and 1958, rising from 1.8 million to more than 4.6 million unemployed. By 1961 the unemployment rate had reached 6.5 percent (which was to remain the highest post-war level until 1975). The result was continuing congressional interest and concern about automation.[5]

A 1961 staff report from the Joint Economic Committee argued that structural unemployment could not be shown to have risen. It said that the rise in unemployment resulted from inadequate aggregate demand—a typically Keynesian argument. This study had considerable influence on President Kennedy and had much to do with his decision to push for an across-the-board tax cut, the plans for which were announced in late 1962 (Heller 1967, pp. 63ff).

Walter Heller, chairman of the Council of Economic Advisors under Kennedy, strongly held the view that technological innovation was necessary and desirable. Permanent technological unemployment was not a problem for two reasons:

1. The existence of poverty and many other pressing economic problems demanded that productivity be increased. They made it highly unlikely that society might become too productive and not provide sufficient meaningful work. "Clearly," he said, "we need not fear that the increasing productivity associated with even a speeded up rate of technological progress will founder upon a contradiction between our needs and our ability to satisfy them. As people continue to receive the extra incomes which our enlarging production can generate, they will also continue to use those extra incomes to buy the enlarged output—for private and public consumption and for investment."
2. Automation was unlikely to cause any major shift in the general skill requirements of the labor force. There was no reason to believe, for example, that unskilled labor would completely disappear, since automation simplified some jobs just as others became more complex. In any case, sensible government policies to encourage education, worker retraining, and labor mobility could mitigate whatever temporary dislocations may result.[6]

[5]See U.S. Congress, House, Committee on Education and Labor (1961), and U.S. Congress, Joint Economic Committee (1957 and 1960).

[6]U.S. Congress, Senate, Committee on Labor and Public Welfare, Subcommittee on Employment and Manpower (1963, pp. 1751–69). See also *Economic Report of the President, 1964*, pp. 85–111.

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The majority of economists continued to believe that automation was not a serious problem.[7] But there were a few voices of doom and despair. Principal among these was Charles Killingsworth, a professor at Michigan State. Killingsworth consistently questioned assumptions about the employment and societal effects of automation, generally taking a highly skeptical view.[8]

The issue was more or less settled by two factors. First was the sharp decline in the unemployment rate, which fell from a postwar high of 6.5 percent in 1961 to 3.4 percent by 1969. Second was the report of the National Commission on Technology, Automation, and Economic Progress, established in 1964 by Public Law 88-444, which was set up to make some final determination of the automation issue. The commission concluded that automation was not a major factor in unemployment:

> We believe that the general level of unemployment must be distinguished from the displacement of particular workers at particular times and places if the relation between technological change and unemployment is to be clearly understood. The persistence of a high general level of unemployment in the years following the Korean War was not the result of accelerated technological progress. Its cause was interaction between rising productivity, labor force growth, and an inadequate growth of aggregate demand. This is firmly supported by the response of the economy to the expansionary fiscal policy of the last five years. Technological change, on the other hand, has been a major factor in the displacement and temporary unemployment of particular workers. Thus, technological change, along with other forms of economic change, is an important determinant of the precise places, industries, and people affected by unemployment. But the general level of demand for goods and services is by far the most important factor determining how many are affected, how long they stay unemployed, and how hard it is for new entrants to the labor market to find jobs.
>
> [Bowen and Mangum 1966, p. 10]

The commission added, "The basic fact is that technology eliminates jobs, not work." Thus it firmly opposed the old "lump of labor" fallacy, which holds that there is only so much useful work to do in the economy and no more. Total employment, in short, is a function of macroeconomic policy. Technology is microeconomic and only affects the composition of jobs within this macroeconomic framework.

[7]Buckingham (1962), Dale (1964), Dankert (1959 and 1960), Fuchs (1963), Hazlitt (1962), Kendrick (1966, pp. 773–7), and Terborgh (1965).

[8]In addition to Killingsworth (1960 and 1965), see U.S. Congress, Senate, Committee on Labor and Public Welfare, Subcommittee on Employment and Manpower (1963, pp. 1461–99).

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The Current Debate

As in the past the current discussion of structural unemployment, technology, and industrial policy is largely a function of abnormally high unemployment rates. Since 1975 the national unemployment rate has averaged more than 7.5 percent, in contrast to an average of 4.6 percent in the 1960s. The average of 9.5 percent between 1982 and 1983 has made concerns about high-tech, robotics, and automation even more frenetic.

Everywhere, one seems to read about how dismal the future will be—with robots doing all the work, the disappearance of our basic industries, and declining standards of living for many Americans. Unfortunately very little analysis underlies most of these books and articles, since most economists continue to believe that our economic problems remain largely macroeconomic. If we could just get monetary and fiscal policy right, they believe, we could get unemployment down to its "natural rate." Of course no one agrees on what the "right" monetary and fiscal policy is, or what rate is "natural," but that is another issue.

The only economist who is seriously working on the problem of technological unemployment is Professor Wassily Leontief. He has largely been skeptical about the effects of automation on work and income (1952; 1982). As I read his work, it follows closely Ricardo's views that by affecting the distribution of income, mechanization may have negative effects on employment. Professor Leontief virtually echoes Ricardo when he says:

> One way of meeting the threat of potential technological unemployment is the creation of new and the maintenance of old jobs through increased investment, i.e., economic growth. But this possibility has definite limits. How fast would the economy, and with it the volume of investment, have to grow in order to keep the number of long-distance telephone operators from decreasing in face of the fact that each of them will soon be able to handle 10 million instead of 1,000 telephone calls? The rate of investment required to accomplish this end might turn out to be so high that very little would be left over for current consumption.
>
> In the pursuit of full employment through a greater and greater volume of productive investment, the society ultimately would find itself in the position of the proverbial miser who deprives himself of the bare necessities of life while depositing more and more into an already swelling savings account, and this despite his steadily increasing annual income. This is exactly what might happen in the long run under the relentless pressure of technological advance, if the forces of unrestricted cutthroat competition were permitted

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> . . . to govern the operation of the labour markets and conditions of employment. [Leontief 1978, p. 452]

I have little doubt that one can construct a theoretical model which would produce such an outcome. One could simply respond that under present conditions it would take so long for such a situation to develop, it would be like worrying about when the sun will burn out, as it inevitably will one day. Or one might use the Keynesian response, that the correct sorts of fiscal policies—for example, redistributing income from investment to consumption—would prevent the development of this situation even if it were theoretically possible.

I would prefer to argue, as Schumpeter did, that Leontief's scenario misses the essential point about the impact of machinery on employment. In responding to Ricardo's argument, Schumpeter (1954, p. 684) said:

> He never clearly realized that the *essential* fact about capitalist "machinery" is that it does what, quantitatively and qualitatively, could not be done at all without it or, to put it differently, that it "replaces" workmen who have never been born.

In addition Ricardo failed to recognize that total output in terms of goods must increase, under conditions of perfect competition (which he assumed) as a consequence of mechanization.

Sir John Hicks (1963, pp. 115–17) has also argued against the Ricardian proposition that progress may so adversely affect the distribution of income that society would be worse off. He did so in the form of three counter-propositions:

1. An increase in the supply of any factor of production will increase the absolute share (that is, the real income) accruing to that factor if the elasticity of demand for that factor is greater than unity.
2. An increase in the supply of any factor will always increase the absolute share of all other factors taken together.
3. An increase in the supply of any factor will increase its relative share (that is, its proportion of the National Dividend) if its "elasticity of substitution" is greater than unity.

Hicks concluded (p. 121):

> [I]t inevitably follows that an invention can only be profitably adopted if its ultimate effect is to increase the National Dividend. For if it is to raise the profits of the entrepreneur who adopts it, it must lower his costs of production—that is to say, it must enable him to get the same product with a smaller amount of resources. On balance, therefore, resources are set free by the invention; and they can be used, either to increase the supply of the commodity in whose production

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> the invention is used (if the demand for it is elastic), or to increase the supply of other commodities (if the demand for the first is inelastic). In either case, the total Dividend must be increased, as soon as the liberated resources can be effectively transferred to new uses.

Herbert Simon (1965) saw the effect of automation as increasing real wages. He argued that almost all of the productivity gains from automation go to laborers, unless automation increases the interest rate. Furthermore Simon concluded that labor-saving technological change increases the amount of capital per worker. According to Simon (p. 22):

> Because of this capacity to generate the necessary capital, the industrializing countries have been able to absorb large amounts of technological progress that, on balance, has been labor saving.
>
> The main long run effect of increasing productivity is [therefore] to increase real wages. . . . If a disequilibrium appears, it will evidence itself first in high profit levels, and the proper measures to restore equilibrium . . . are to encourage rapid public or private capital formation, which will come about at least partly because of the profits themselves.

Hence, as a matter of theory, there seems to be little reason to suppose that mechanization, automation, or any other factor causing output per unit of labor to rise is of serious concern. The only thing which would justify a more pessimistic outlook would be something which prevents prices and wages—and therefore capital and labor—from adjusting to changing economic conditions. There is nothing in theory which shows that under free-market conditions technological progress can do anything except make everyone better off.

Summarizing this position, a leading scholar in the field, Professor Nathan Rosenberg of Stanford, recently told the House Subcommittee on Science, Research, and Technology:

> I do not believe that high unemployment has been primarily due to the character of technological change, nor do I see any compelling reason to believe that new technologies will have an unusual job-reducing bias in the future. Some categories of employment will, of course, suffer.
>
> Technological change always has reduced specific categories of employment, whether it is farm workers, coal miners, railroad workers, lumberjacks, whatever. The electric light displaced the candlemaker and the automobile put saddlers and whipmakers out of business. The crucial question, it seems to me, is whether the thrust of technological change is to reduce total employment, not whether it eliminates specific jobs. . . .
>
> It is extremely difficult to anticipate the impact of new innovations because this impact is never something which is inherent in a piece

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of hardware. It depends rather on social uses and cultural contexts, on how society chooses to mobilize the technological potential of a piece of hardware.

So that I believe there is a systematic bias in our perception about the future. This bias sharpens our awareness of possible job-reducing consequences of technological change, but at the same time fails to identify the prospects for enlarged employment opportunities that flow from the ability to produce certain products more cheaply or to invent entirely new products with quite unanticipated uses and applications. . . . What I want to insist upon, in closing, is that I see no evidence to support the expectation that technological innovation is now poised to inflict unemployment of a vastly enlarged scale as compared with our historical experience.

[U.S. Congress 1983, pp. 32–34]

Some Empirical Data

A brief review of some of the empirical data which bear on the argument will be reviewed in this section. The preponderance of this evidence shows that labor invariably benefits from increasing capital formation, productivity, and technological innovation.

First let us look at labor's share of national income over the last 50 years. Obviously there has been considerable capital formation and technological innovation over this period. If there were any validity to the argument that labor suffers from such factors, it should show up as a decline in employee compensation as a share of national income. In fact, as Table 1 shows, this has been almost continually rising.

TABLE 1

TOTAL EMPLOYEE COMPENSATION AS A SHARE OF NATIONAL INCOME

Year	Labor's Relative Share (%)
1930	63.4
1940	65.4
1950	65.1
1960	70.9
1970	75.5
1980	75.6
1983	75.2

SOURCE: National Income and Product Accounts.

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Another concern might be that rising productivity will be used to produce the same output with less labor, rather than to increase output. If this were so, one would expect to see increases in productivity associated with declining employment. But as Figure 1 demonstrates, increased productivity in the economy is invariably associated with rising, rather than declining, employment. Only four years since 1948 reveal both increased productivity and reduced employment.

It is all the more remarkable that employment growth is positively correlated with productivity growth when one considers that average weekly hours worked has not changed much over the postwar period. Professor Leontief and others have suggested that the workweek may need to be shortened if future productivity is not to lead to unemployment.

The data show two things: that people have preferred to have higher real incomes rather than increased leisure during their working lives, and that people have tended to take their leisure in the form of increasingly early retirement rather than shorter workweeks. Table 2 shows that over the period 1947 through 1981, per capita gross domestic product has risen at an average annual rate of 2.1 percent, while average weekly hours worked has fallen only slightly. Had workers preferred to take all of the productivity increases over this period in the form of shorter hours rather than higher incomes, average weekly hours could have fallen 2.6 percent instead of just 0.4 percent.

TABLE 2

AVERAGE ANNUAL RATES OF CHANGE IN GDP PER CAPITA AND AVERAGE WEEKLY HOURS, 1947–81

	Average Annual Percentage Change	
Years	GDP Per Capita	Average Weekly Hours
1947–65	1.8	−0.4
1965–73	2.3	−0.7
1973–81	1.8	−0.5
1947–81	2.1	−0.4

NOTE: GDP is Gross Domestic Product.
SOURCE: Bureau of Labor Statistics.

Table 3 shows labor force participation rates for persons age 65 years and over since 1948. As one can see, the number of people age

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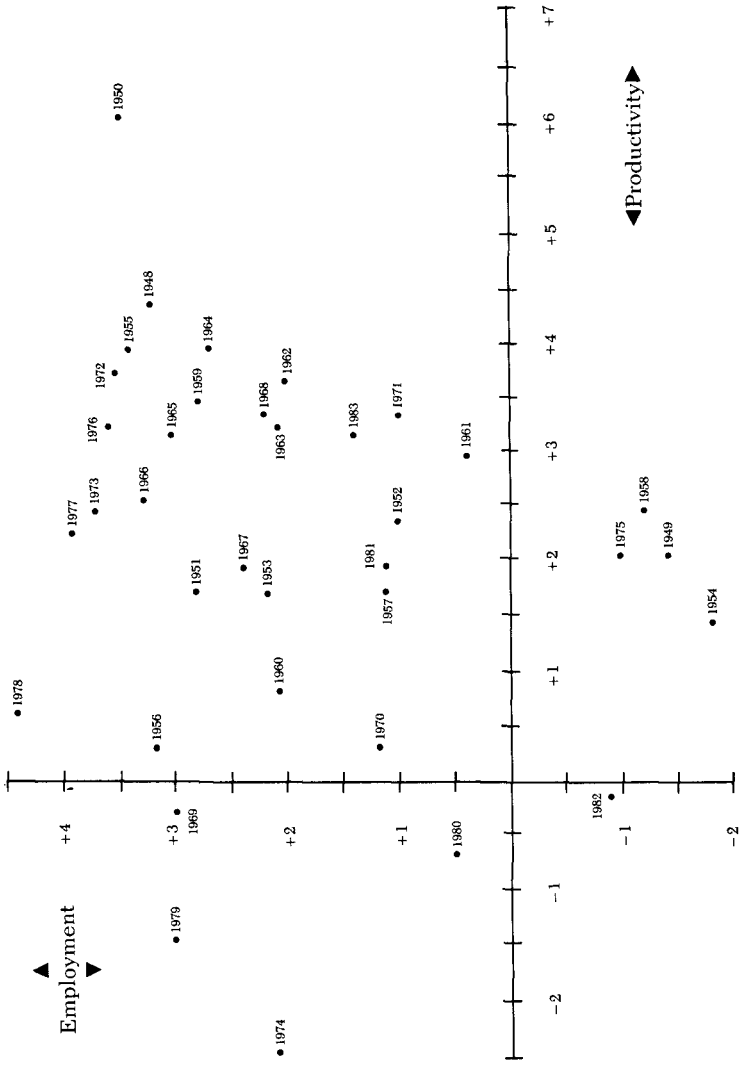

FIGURE 1
U.S. EMPLOYMENT-PRODUCTIVITY RELATIONSHIP

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TABLE 3

LABOR FORCE PARTICIPATION RATES FOR PERSONS AGE 65 YEARS AND OVER, 1948–82

Year	Labor Force Participation Rate (%)
1948	27.0
1966	24.1
1960	20.8
1965	17.8
1970	17.0
1975	13.7
1980	12.5
1982	11.9

SOURCE: Bureau of Labor Statistics.

65 or over who still work has fallen sharply and consistently since 1948. In 1948, 27 percent of all people over age 65 were still working. By 1982 only 12 percent still worked. This is all the more remarkable when one considers the increase in life expectancy and health over this period. Thus it would seem that people prefer to take their increased leisure all at once, so to speak, rather than a little bit at a time through reduced weekly hours. To the extent that increased leisure is desirable or necessary to offset rising productivity in future years, therefore, there is no reason why it must come in the form of a shorter workweek. People may simply continue the trend toward earlier retirement instead. Either way the effect on lifetime hours worked would be the same.

Another question is whether mechanization and automation are adversely skewing the income distribution, as Lester Thurow and others have argued. Table 4 shows the shares of income for various income classes since 1947. The data show no trend toward greater income inequality, despite enormous structural changes in the economy over this period. In 1947 the share of income going to the top 5 percent was 17.5 percent of the total. In 1982 it was 16 percent. In 1947 the share of income going to the middle three-fifths was 52 percent; in 1982 it was 52.6 percent. Robert Samuelson (1983, p. 2673) concludes: "[T]here is no indication that 'high-technology' or 'service' jobs are splintering the middle class."

Conclusion

Historical and theoretical evidence argue against the idea that technological innovation will create permanent unemployment. Those

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TABLE 4

SHARES OF INCOME FOR SELECTED YEARS
(Percent Distribution of Aggregate Income)

Year	Lowest Fifth	Second Fifth	Middle Fifth	Fourth Fifth	Highest Fifth	Top 5 Percent
1947	5.0	11.9	17.0	23.1	43.0	17.5
1950	4.5	12.0	17.4	23.4	42.7	17.3
1960	4.8	12.2	17.8	24.0	41.3	15.9
1970	5.4	12.2	17.6	23.8	40.9	15.6
1980	5.1	11.6	17.5	24.3	42.7	16.0

SOURCE: U.S. Department of Commerce, Bureau of the Census.

who conclude otherwise are usually mechanically extrapolating from current trends, without considering the new jobs that may be created—jobs that the Bureau of Labor Statistics has not thought of yet. As historian Daniel Boorstin recently observed:

> People said the telephone would replace the mails, the radio would replace the telegraph, the TV would replace the radio. But what new technology does is discover unexpected roles for the old. Who would have thought people would walk around wearing radios, or that radios would play the role they do in automobiles?[9]

Since the manner in which society will ultimately deal with technology is, by definition, unknown, it is rather foolhardy even to attempt to project the employment effects of technology. The ultimate impact of the computer may come in ways we cannot even imagine today.

It is interesting that the only major effort to project the impact of automation on employment, while considering interrelationships among industries and technologies, was done by Professor Leontief using an input-output model. This model is of interest specifically because it showed that once all the interrelationships were worked through, technological unemployment was not predicted to be a significant problem in the year 2000 (Leontief and Duchin 1983). This result, however, seems to run counter to Professor Leontief's earlier statements (Leontief 1982). Perhaps it only proves that the deeper one delves below the superficial notion that automation automatically creates unemployment, the more likely one is to conclude that it does not.

[9]*Quoted in* Krucoff (1984).

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"IS INDUSTRIAL INNOVATION DESTROYING JOBS?": A COMMENT

Leland B. Yeager

Worries that technological progress threatens chronic unemployment go back several centuries but keep popping up in superficially modernized versions. The relevant theories and evidence need reviewing from time to time. Mr. Bartlett (1984) deserves congratulations on his extensive and judicious review. Once again Luddite worries have been answered.

A discussant is expected to raise some quibbles. Let us put them behind us at the start. I am skeptical about some of the evidence Bartlett provides. Table 1, for example, showing employee compensation rising as a share of national income between 1930 and 1983, proves less than may appear at first glance; for employees, as distinguished from farmers and other self-employed persons, were composing a growing share of the total labor force. The loosely scattered points for particular years in Figure 1 again do not prove much. Bartlett's general argument does not depend on the questionable tables and charts, however. They serve as little more than decoration anyway.

As Bartlett says, technology is a micro matter, affecting the industrial pattern of employment. Total employment and total unemployment are largely macroeconomic phenomena, depending on macroeconomic policy and on how swiftly markets and wage- and price-setting processes can cope with macroeconomic disturbances.

Suppose technological advance raises productivity in a particular line of production. If demand for its products is sufficiently price-sensitive, employment even in that particular line may rise. If the demand elasticity is not that high, the increased real output in the technologically advancing sector still constitutes additional real power to demand the outputs of other sectors.

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Say's Law, as interpreted by W. H. Hutt in particular, is relevant here. Bartlett makes pretty much the same point. Fundamentally, in an advanced economy, people specialize in producing particular goods and services to exchange them away for the specialized outputs of other people. Any particular output thus constitutes demand for other (noncompeting) outputs. Technologically improved capacity to produce some things constitutes increased capacity to demand other things and so to demand the inputs for making them. Since supply constitutes demand in that sense, there can be no fundamental problems of oversupply on the whole in relation to demand.

Any apparent problem of that sort traces to impediments to exchanging goods and services for each other, impediments that discourage employing labor and other factors to produce goods destined for exchange. Exchanges and production and employment may be thwarted—markets may fail to clear—because of wrong prices. Wrong relative prices may conceivably be the difficulty. Realistically, though, the more important difficulty—to judge from the abundant evidence supporting the monetarist theory of business fluctuations—is a wrong overall wage and price level in relation to the nominal quantity of money. For various compelling reasons, price setters and wage negotiators can hardly be expected to cope swiftly with monetary disturbances. Attention should focus, therefore, on money and monetary policy. One can hardly make sensible recommendations about employment and unemployment without understanding the macroeconomics involved, that is, the monetary theory. I suppose Bartlett and I agree on this familiar but crucial point.

We may make one concession to those who focus on the micro effects of technological progress. A changing world means a changing pattern of employment, with persons temporarily unemployed while changing jobs. Some persons become unemployed more than temporarily, particularly those nearing retirement age. If technological progress should grind to a halt, however, and if, in addition, consumers' tastes should cease changing—if economic life should come to rotate indefinitely in the same old ruts—then workers and jobs would come to match each other in the fullest conceivable degree. Frictional unemployment would be at a minimum.

Would we really want this stagnant state of affairs? Technological progress raises incomes and wealth and so incidentally raises people's individual or collective capacity to cope with unemployment between jobs.

An economy with improving opportunities for workers and consumers and investors and entrepreneurs is bound to be a world of change. One response to change is resistance—protectionism in the

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broadest sense. It tends to concentrate the burdens of change on those sectors and persons that, perhaps for political reasons, are relatively least able to obtain protection. (Protection is, after all, a relative matter. All-around equal protection is a nonsensical concept.) A different response is characteristic of a free-market economy. Business firms and workers facing new competition or adverse shifts in consumers' tastes have the option of slowing the loss of customers and jobs by accepting reduced prices and wages while seeking more attractive opportunities for adjustment. In a free economy, workers, businessmen, and investors can sort themselves into more and less risky lines of endeavor according to their own diverse tastes for chances of gain balanced against risks of unemployment or loss. Entrepreneurs will discover ways of making mutually advantageous offers to displaced workers and owners of displaced productive assets. Safety nets will be provided by private and perhaps by governmental programs.

Bartlett has been dealing with complaints about one particular respect in which the real world is deemed unsatisfactory—unemployment attributable to technological progress. Almost unlimited anecdotal evidence can be found to support any particular complaint. It is easy to trot out evidence that job opportunities have been shrinking in connecting telephone calls or setting type or picking crops. It is easy to commit the fallacy of composition and imply that the particular shrinkages will add up to shrunken total employment.

With regard to employment and unemployment, as with regard to other problems of a changing world, it is routinely easy to maintain that somebody, meaning the government, should do something. The idea of an industrial policy gains strength from its vagueness. Everyone wants the right measures taken. Industries and jobs that are the wave of the future should be encouraged; declining industries and their workers should be helped to make adjustments. (Politicians do not, of course, talk of actually phasing out particular industries and jobs.) It is easy to overlook the fact that, in a world of scarcity, steering resources and demands toward particular occupations entails steering them away from others. It is easy to overlook the costs while emphasizing the benefits of proposed measures.

Overlooking costs is especially easy for participants in the political process. They may forget, for example, that government credit programs and even government credit guarantees divert credit into some uses *and away from others.* Is it possible, I wonder, that politicians and their audiences overlook the central fact of economics? Resources are scarce, and allocating some to particular lines of production means withholding them from others. Someone might object that this point

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does not apply at times of depression and general unemployment. As Bartlett and I have argued, however, such conditions, in which the central fact of scarcity apparently fails to hold, are a phenomenon to be understood by macroeconomics and monetary theory.

Industrial policy appeals to a spurious consensus. (Insightful remarks occur in Hayek 1944, pp. 54–55, 61–71.) People want the right measures taken, of course; but different people have different ideas of what specific measures are the right ones. Special economic interests, politicians, and bureaucrats can see opportunities to shape industrial policy to their own particular advantage.

Talk of industrial policy "meets the politicians' need to sound modern and intellectual but is sufficiently vague to avoid sharp analysis and criticism." Ad hoc interventions to "assist" American industry to adjust to a changing world economy overwhelmingly take "the form of protecting existing industries rather than promoting adaptation to new ones. It is no accident that this has happened. That is the nature of politics and of the bureaucracy" (Stein 1984, p. 365).

Controlling a market economy through ideal interventions would require the controllers to have the same knowledge of wants, resources, technology, and all sorts of local and fleeting details that planners would need to run a centrally planned economy successfully. The whole vast literature on economic calculation under socialism is relevant here.

So are the contributions of the public-choice theorists to our understanding of the political system. Can anyone still seriously believe that the democratic process is capable of producing a coherent program of detailed interventions sensibly oriented toward national economic objectives? In governmental decision making, responsibility is fragmented, remote and long-run repercussions relatively neglected, and economic theory often scorned.

Consider the minimum-wage law and how it affects the opportunities of young people, particularly disadvantaged young people, to get a start on the economic ladder and so gain in experience, in self-respect, and in worth to employers. If the political system will not behave sensibly even on this relatively clear issue, what earthly reason is there for expecting it to behave sensibly in exercising the increased power over the pattern of economic activity and the level and pattern of employment that the devotees of industrial policy want to give to it?

Shortly before the start of our conference, the directors told me that Professor Leontief would not attend after all and that I should try to fill the gap by rambling on for several extra minutes. In the absence of the case for an activist industrial policy that Professor

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Leontief would probably have provided, we must turn out attention to what Congressman LaFalce said in his opening remarks.

LaFalce gave us a prime example of political argumentation. His delivery—his professional eloquence—was effective, and the substance of his message was *plausible.* He warned us of a false dichotomy—central planning *or* the market. (Professor Etzioni, in his remarks, also warned against polarization of the issue.)

Shouldn't we be *concerned,* LaFalce asked, with lagging productivity, with the problems of particular industries, with impending growth of Japanese shares in American markets, and even with the thousands of lobbyists in Washington seeking specific bits of industrial policy? Who is to examine the various policies and proposals? Who will undertake coordination? Don't we need a forum for discussion? Shouldn't the U.S. government impose conditions in return for its assistance to particular industries, as the International Monetary Fund does in aiding countries?

LaFalce apparently thinks that lack of enthusiasm for proposed legislation betrays lack of concern about the targeted problems. He prefers a positive stance. This view is understandable. Politicians do their job, and gain attention, by perceiving problems and offering solutions.

The unsatisfactory character of industrial policy so far—LaFalce mentioned the existing hodgepodge of government banks for various purposes—itself serves as an argument for pursuing rationalization and coordination through new committees and commissions. Pointing to the sorry record so far draws from the activists the reply: "Precisely! We're going to change all that" (if I may paraphrase Molière). Nothing succeeds like failure.

In certain circles the need for industrial policy is taken as axiomatic, like—as P. T. Bauer has observed—the need for central planning in underdeveloped countries. "Indeed, once a case is treated as axiomatic empirical evidence becomes irrelevant. Whatever the actual course of events, it can always be adduced in support of a policy which is axiomatically deemed desirable: progress as evidence of its success and lack of progress as evidence of the need for its reinforcement"(Bauer 1972, p. 73).

Professor Etzioni published a psychological article in 1972 on people's propensity to look to Washington for solutions to all sorts of problems. Etzioni noted the empty, symbolic character of many ostensible solutions. Speeches are made, conferences held, commissions appointed, bills passed, agencies established, funds appropriated, and programs launched, often doing little of substance to treat

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the problems involved, some of which were mere pseudoproblems in the first place. Yet activist politicians get credit for being *concerned.*

A good understanding of economics must be something of a handicap for a politician. It inhibits either his promise-making or (unless he is a good actor) his projection of sincerity, and neither inhibition helps him play the political game.

I further conjecture that the members of the councils and commissions that Congressman LaFalce wants to establish will tend to be persons amenable to rhetoric like his. We should take note of what sort of argumentation over economic issues tends to flourish in the public and political arena. TV viewers and newspaper readers have short attention spans, to judge from how the media strive to grab their attention by oversimplifying and overdramatizing issues and linking them with disputes between colorful personalities. Now, how many more of the decisions in our economy do we really want to subject to this sort of argumentation?

In conclusion, I'd like to try to relieve the audience and myself of some worries. Let's not worry about accusations of falsely polarizing the issue we have been discussing into one of government planning *or* the market. Let's not be intimidated by the argument that we always have had and necessarily must have some sort of industrial policy or the other and that the only live question is *what sort.* We are expected to accept the rhetoric about framing policy consciously and in a coordinated way rather than haphazardly and piecemeal.

Yet such rhetoric does not justify an activist industrial policy, a policy of displacing market processes and giving more and more influence to the political process and to politicians, lobbyists, and self-styled experts. After all, an alternative remains, as Professor Rabushka and Mr. Albertine have reminded us. It is the alternative of stripping away the negative, the counterproductive, the fragmented and illogical industrial policy that we have experienced so far.

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THE CASE AGAINST "INDUSTRIAL POLICY"

James C. Miller III

Introduction

As a professional economist, I have a deeply-rooted skepticism about the capacity of government to manage economic growth or technological change more efficiently than the free market. As chairman of the Federal Trade Commission, moreover, I am officially charged with keeping a suspicious watch on interference with free competition—even when such interference is sponsored by government itself. In the early 1930s, for example, the FTC played an active role in criticizing several of the anticompetitive industry "codes" sponsored by the ill-fated National Recovery Administration. Thus from where I stand it seems to me the burden of proof ought to be on those who advocate ambitious new ventures in governmental management of the economy.

There is no doubt the American economy has been through some very rough weather in the last 15 years. And like any patriotic American, I find myself stirred by the cry that we can and must do better in the remaining years of this century. But for the life of me, I cannot believe the answer lies in current proposals for an activist industrial policy. I come to this judgment for three simple reasons: first, proposals for activist industrial policy begin with faulty history; second, they proceed through untenable economic reasoning; and, third, they conclude with deluded political projections. In sum they are bad history, bad economics, and bad politics—three strikes that should declare a policy "out" in any league. Let me explain.

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The author is Chairman of the Federal Trade Commission. The views expressed are his own and do not necessarily reflect the views of the other commissioners. This paper is adapted from Chairman Miller's remarks at the Cato Institute's conference, "Planning America: Government or the Market?" (April 27, 1984).

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Bad History

By almost any measure the United States is the richest country in the world. Our immense economic success has been achieved, for the most part, by reliance on the free market. Most people, of course, would be rather reluctant to abandon an approach that has worked so well in the past. The advocates of an activist industrial policy, therefore, seek to persuade us that our economy has actually been faltering over the past 15 years—that our industrial base has been dwindling and "unraveling." They warn us that our major international competitors have been steadily outperforming us—thanks to their embrace of centralized, governmental "industrial policies." If we do not learn to adopt these foreign methods, we are told, the United States will fall further and further behind, winding up as a humble provider of raw materials for the new economic superpowers of the 21st century.

At least in psychological and political terms, this alarming depiction of recent trends is crucial to the case for an activist industrial policy. But the picture is simply not true. It is based on a substantial misreading of economic trends over the past decade and a half. Let me briefly highlight a few aspects of recent economic history that strike me as most fatal to the case for an activist industrial policy.

First, the American economy actually displayed significant, broad-based growth during the 1970s—despite three recessions, repeated bouts of double-digit inflation, and an enormous escalation in energy costs. Total employment in the United States increased by 26 percent in the course of the decade. By contrast, employment in Japan increased by only 8 percent in this period, and the West German economy actually employed fewer workers in 1980 than it did in 1970.

Second, it is not true that this growth occurred only in peripheral service activities, at the expense of basic industrial production. Of the major industrialized nations, in the 1970s only Japan and Italy actually experienced higher rates of growth in industrial output. West Germany's industrial output increased at barely 60 percent of the American rate. During the decade, higher growth in other sectors did lead to a slight decline in the *relative* share of our GNP represented by manufacturing, but this was also true in most other countries. Indeed, in West Germany, Japan, and Great Britain the manufacturing share of GNP fell much more sharply.

Third, it is not true that American industry has been growing continually less competitive in world markets. The volume of manufactured goods exported from the United States increased by 100 percent between 1970 and 1980, while comparable exports from the

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European Economic Community increased by only 84 percent over the same period. As recently as 1978 through 1980, U.S. exports were growing twice as fast as overall world trade, and by 1981 U.S. manufacturers had regained the total share of world markets which they had held in the late 1960s. Exports of high-technology goods, in particular, increased at an accelerating pace in the late 1970s—and far exceeded imports in this area. While it is true that our trade balances deteriorated substantially after 1981, this seems almost entirely attributable to secular changes in exchange rates, due in part to the greater speed of the American recovery, compared with those of our major trading partners. On the evidence of the last decade, then, there is no reason to assume American industry is losing its competitive edge in any fundamental respect.

No doubt certain of our traditional industries, such as autos and steel, have suffered greatly from foreign competition over the past 15 years. But these are highly unionized industries which have allowed their wage rates to climb far out of proportion to prevailing rates in other manufacturing sectors, while also laboring under a number of peculiarly adverse regulatory and tax policies. The foregoing data should make it clear that generalizations based on reverses in these few industries give a very misleading picture of our overall economic performance. To its credit, the report of Congressman John J. LaFalce's Subcommittee on Economic Stabilization (U.S. Congress 1983) does not indulge in the apocalyptic rhetoric that has often been adopted by the political patrons of these few industries. But by omitting all this encouraging information and relying on impressionistic assessments of particular problem areas, it does tend to obscure the enduring strengths of the American economy.

Finally, a word about productivity, on which the subcommittee report dwells at some length. Growth in labor productivity slowed to an alarming degree during the 1970s, true enough. But roughly comparable slowdowns were experienced by all other industrial nations during this period, even those which had earlier witnessed far higher rates of productivity gain. While the American performance seemed to put us near the bottom of the list of major industrial countries on this indicator, the statistics may be misleading. As George Gilder has recently emphasized, the enormous growth in the American labor force during the 1970s—as women, new immigrants, and young people of the baby boom generation flooded into the market—inevitably reduced capital formation per employed worker. Western Europe and Japan, without this great expansion in employment, naturally did not display the same statistical effect in their aggregate productivity figures (Gilder 1983, p. 37).

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I am convinced that burdensome tax and regulatory policies also played a significant role in depressing real productivity growth in the United States during the 1970s. The reforms introduced by the Reagan administration in these areas now seem to be bearing out this diagnosis. Since 1980, productivity has been rising at an annual rate of 1.6 percent—more than twice the dismal pace of the 1973–80 period. And in 1983 productivity grew by some 2.6 percent—well above the average annual gains of the last 60 years. No exotic "industrial policy" was required. As the late Martin Diamond, my colleague at the American Enterprise Institute, used to say: We must have the courage to face the truth—however cheering it may be. In my view, then, a realistic assessment of our recent economic history simply cannot support the fearful interpretations that advocates of industrial policy have sought to draw from it.

Bad Economics

If an accurate history of our recent economic performance does not scare us into an activist industrial policy, might such a policy nevertheless still be worthwhile? I would certainly agree that we should aim to do better than we did in the 1970s. But the arguments advanced for an interventionist industrial policy as a superior economic approach seem quite implausible, and the evidence from other countries seems only to cast further doubt on these claims.

Advocates of an activist industrial policy have repeatedly called attention to the disturbingly low rates of capital investment in the United States over the past 15 years, especially compared with the rates experienced by other advanced industrial nations. On this they will get no quarrel from me, nor I suppose from any economist. Future expansion depends on adequate current investment, that seems pretty clear. And, of course, President Reagan's economic policy was designed precisely to address this concern—by curbing inflation and reducing taxes—thus encouraging private saving and long-term direct investment by business. In fact this program seems to be working, with business investment having climbed impressively over the past 18 months. No doubt the tax code could be still improved to provide even more encouragement for people to save and invest.

The advocates of an activist industrial policy claim the Reagan approach is insufficiently "targeted"; that is, insufficiently "discriminating." They insist government must go beyond encouraging savings and investment in a general way and must instead attempt to manage the content and strategy of investment within and among particular industries. Congressman LaFalce's subcommittee thus

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proposes three new governmental entities, responding to what it portrays as three enduring structural problems in our economy: first, a Council on Industrial Competitiveness (CIC) to remedy our deficiencies in assessing microeconomic trends; second, a Bank for Industrial Competitiveness (BIC) to remedy the lack of "patient capital" for long-term speculative investments; and finally, an Advanced Technology Foundation (ATF) to remedy the inadequate support for high-tech research and development efforts in American industry (U.S. Congress 1983, p. 29). For all the rhetoric of "competitiveness" surrounding these proposals, they all seem to me to reflect a basic misunderstanding of what economic competition is about and why it is so essential to economic development.

CIC, for example, would supposedly synthesize insights about international trade opportunities with information about "the problems and promises of specific industries or sectors," as provided by particular "Industry Subcouncils" (p. 32). The subcommittee report tells us quite forthrightly that the purpose of this whole apparatus would be "to build a consensus about common economic problems" because "[c]onsensus-building must . . . be the principal cornerstone of anything called 'industrial policy' or 'industrial strategy' " (pp. 31–32).

But why this eagerness for "consensus"? As an enforcer of the antitrust laws, I admit I may be unusually suspicious of efforts to "build consensus" among competing firms. But even speaking simply as an economist, I must say I do not see what is so great about consensus. The central virtue of competition is that it stimulates innovation, reserving the greatest rewards precisely for those who break from established patterns. Anyone can follow a settled consensus; a competitive economy forces individual firms to look ahead, to be imaginative, to take risks—and fundamentally this is what drives economic development.

The subcommittee report says CIC would develop a "significant research staff" and a detailed "public data-base" because it "ought to know more about the state of our economy than do securities analysts on Wall Street" (p. 32). Well, I am sure many of us have had occasion to wish our stockbrokers had access to better information. But it is an illusion to suppose the element of risk in investment decisions could be significantly reduced just by making more information concerning economic activity publicly available. While we policymakers never seem to have enough information, the most crucial investment questions turn not on descriptions of the status quo, but projections into the future—which is always fraught with contingency and uncertainty. Only a stagnant economy is entirely predictable.

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Moreover it is hard to see why a body of governmental experts would be any better at betting on the future—with other people's money—than hundreds of thousands of business executives and private investors, with their own wealth at risk.

The superiority of government experts is especially hard to credit when one recalls they would be gathering their prognoses from the consensus of established firms. If we had had a CIC in the early 1970s, would it really have foreseen the emerging threat to the American auto industry from Japanese imports? Perhaps CIC would have anticipated the success of the OPEC cartel in forcing up gas prices—as neither Henry Kissinger nor Milton Friedman did—and correctly project from this a vast new market for small, fuel-efficient cars.

Perhaps. But Japan's celebrated Ministry of International Trade and Industry (MITI), touted as an inspirational model of guiding expertise in the subcommittee report, was, in fact, no more prescient in this matter. In the 1960s it tried to consolidate several aspiring auto companies, and at one point proposed that the entire industry be merged into just two firms—Nissan and Toyota. MITI not only tried to discourage Toyota and Nissan from earlier attempts to penetrate the American market but later pursued the same pessimistic line with Honda when that company launched its own daring expansion into the American auto market in the mid-1970s.

The proposals for a government industrial bank and a publicly funded technology foundation tilt against the same economic logic and experience from the opposite direction. Just as American business has a "tendency to be 'blindsided' by foreign competitive threats which could easily have been foreseen," the subcommittee report assures us (p. 32), so it is also unduly backward in exploiting emerging opportunities. We are told that BIC would alleviate the shortage of "patient capital" for promising long-term ventures, while ATF would compensate for inadequate business investment in research and development. Now, as I have said, almost everyone agrees that general monetary and tax policies should indeed be very attentive to these concerns. But the idea of targeting government subsidies on selected industries or technologies of "promise"—as designated by the crystal-ball gazers in CIC or ATF—seems again to misconceive the virtues of competition.

If businesspeople and investors do not generally exhibit a great deal of patience with new ideas, that is no doubt largely attributable to the fact that most new ideas do not, after all, turn out to be good ideas or economically viable ideas in the prevailing circumstances. The patent office is crammed with the designs of barren inventions; patience is often no more than a prelude to failure. The trade

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ministries in Britain and France patiently poured more and more capital into developing a supersonic passenger aircraft in the early 1970s—and were rewarded for their patience with the Concorde, a financial white elephant of international proportions. Japan's MITI patiently poured capital subsidies into that country's developing shipbuilding industry in the 1970s—and those "promising" new shipyards reduced their tonnage by about two-thirds from 1973 to 1978, and laid off some 46,000 workers between 1977 and 1983 (Boyer 1983).

These are by no means isolated exceptions. But since I have often been critical of others for basing policy on purely anecdotal evidence, perhaps we should not make too much of them. It is notable, however, that the subcommittee report fails to offer a single concrete example of *successful* governmental ventures in promoting new industries, let alone demonstrate that such successes really required governmental assistance to succeed. In my judgment it would surely take a great many such examples to make a convincing case that government officials would do a better job than millions of competing private investors.

Of course an aggregate of millions can include a great deal of foolishness along with some rare brilliance. But competition at least forces producers and investors to keep revising their judgments about which is which. Freed of the creative discipline of competition, government can be more patient than the market or more enthusiastic about new technologies, but there is every reason to doubt it will prove wiser in the long run. As Charles Schultze, chairman of President Carter's Council of Economic Advisers put it (1983, p. 12): "No matter that for every one winner in the race, there are nine losers—you can be sure the U.S. government's portfolio, twenty years later, would still have all ten."

This would be so even if we thought of government as nothing more than a conscientious investor. But, of course, no one does. Government is inescapably political. Advocates of an activist industrial policy rarely take this into account, however. If their proposals are implausible in their economic reasoning, they seem to be even more fanciful as political science.

Bad Politics

The report of Chairman LaFalce's subcommittee, for example, disavows any comparison between the old Reconstruction Finance Corporation (RFC) and its proposed BIC. Doubtless this was prudent, for the dismantling of the RFC in the early 1950s was provoked

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by acrimonious congressional investigations, which exposed repeated episodes of cronyism and partisan manipulation in RFC loan policy. Instead the subcommittee invites us to consider its proposed bank as somehow akin to the International Monetary Fund (IMF). But the IMF deals only with governments, not with individual firms or industrial subsectors. And more important, it is not controlled by the recipients of its largesse but by the contributors of its capital, much like a business corporation. Thus the U.S. government, which provides 25 percent of IMF funding, retains 25 percent voting control over its decisions.

How would controling shares be distributed in the institutions that formulate or implement an activist industrial policy? Surely we would not reckon up different categories of taxpayers and accord them representation in proportion to the scale of their payments to the Internal Revenue Service. The subcommittee indicates that BIC and ATF would both draw their "policy guidance" from CIC. But who would guide CIC and its industry subcouncils? It is rather striking the subcommittee report says nothing about the influence the president or Congress would supposedly have on this body. We are not even told how the members would be appointed or on what terms they would serve. Instead we are simply told the membership of the CIC and its subcouncils would be "reflective of the major participants in our economy . . . drawn from the highest levels of leadership of busines, labor and academia . . . participating with top-ranking government officials and with national leaders representing other public interests" (pp. 32–33).

Pause for a moment over that catalogue and then ask yourself who these leaders might be and by what criteria they would be identified. Who ranks in the "highest levels of leadership of business"? If CIC had existed 10 years ago, who would have represented the computer industry? Presumably IBM and a few other corporate giants—some of which, like RCA, have since been driven out of the computer field altogether. Would CIC even have consulted, let alone recruited, those entrepreneurial geniuses who have developed the market for home personal computers in recent years? These men and women were unknowns at the time: their companies did not even exist. Perhaps an industry "leader" would have assured the CIC there was simply not much of a market for home computers—a conviction IBM apparently held until quite recently.

Who would represent the "highest levels of business leadership" on the issue of trade barriers? Surely the sheer size of the auto and steel industries would ensure a major say for those who stand to gain from restrictions. What about struggling young technology

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companies which *may* become corporate giants in 10 or 15 years? Would their preferences for free trade be given equal weight merely on the strength of their *possible* future importance?

Balancing the status quo against the future would be only the beginning of the difficulty. Another problem would be to ensure fair representation of the unorganized against the organized. The leaders of major unions, for example, would surely claim to be the "highest levels of leadership" for labor. But who would speak for the still larger portion of American workers who do not belong to any union?

Somehow CIC and its subcouncils would not only make everyone feel represented but arrive at a "consensus" and "mobilize wide public endorsement for their strategies." Think of that. Milton Friedman and John Kenneth Galbraith, Ralph Nader and Jerry Falwell, Detroit and Silicon Valley—just give them a prestigious forum like CIC and they will arrive at a consensus acceptable to the whole country. Congress cannot even work out next year's federal budget without acrimonious wrangling, and even then almost everyone complains it has been wastefully pandering to special interests—always the special interests of the other guys, of course. Does anyone really believe CIC and its subcouncils would find it easier to agree on policy because the scope of their concerns would be expanded to embrace the whole economy? Or that their decisions would carry greater moral authority because the council members would be chosen by those with a better eye for leadership quality than the mere mass of voters?

The founders of this country were not so naive, The *Federalist* observed that "the latent causes of faction are sown in the nature of man" (Rossiter 1961, p. 79). It concluded that the only sure way of removing selfish factionalism in politics would be "by destroying the liberty which is essential to its existence"—a remedy . . . worse than the disease" (p. 78). Rather than pursuing the vain hope of consensus, the *Federalist* placed its hope in the likelihood that in a large country the very number and diversity of political factions would be an important and much-needed restraint on government. Our Founding Fathers, many of them students of Adam Smith, undoubtedly recognized that limited government would be more conducive to economic growth. But they were perhaps more inspired by their appreciation of what limited government could contribute to political stability and civic peace. The decisions of the market do not require a consensus. But attempts to impose a consensus on detailed aspects of economic development would be bound to provoke embittered factual conflict.

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Concluding Remarks

In closing I want to acknowledge one great merit of the argument for industrial policy. It is quite true, as Congressmen LaFalce's subcommittee stresses, that the federal government has already established a wide variety of subsidies, trade barriers, and regulatory schemes to protect or promote particular industries. These programs have grown up piecemeal over several decades, and most were presented at their inception as mere incidental exceptions to the accepted rule of nonintervention. But now there are so many exceptions that the advocates of an activist industrial policy, with much justice, can claim they are simply proposing to do systematically and comprehensively what we have already been doing halfheartedly or absentmindedly. By the same token, if we are persuaded to reject their proposals for an activist industrial policy, we may well be inspired to reconsider the many existing programs that reflect similar fallacies and similar dangers.

In his celebrated argument for liberty of thought and discussion, John Stuart Mill observed that "a strong opinion . . . however true it may be, if it is not fully, frankly, and fearlessly discussed, it will be held as a dead dogma not a living truth" (Lerner 1961, p. 285). I believe that to be true; it is one more example of the virtue of competition. I, therefore, want to express again my genuine appreciation to Congressman LaFalce and other advocates of an activist industrial policy for challenging those of us who defend the free market to rearticulate and revitalize our own arguments. I still think their proposals are ill-conceived, but I am sure they are stimulating a very valuable national debate.

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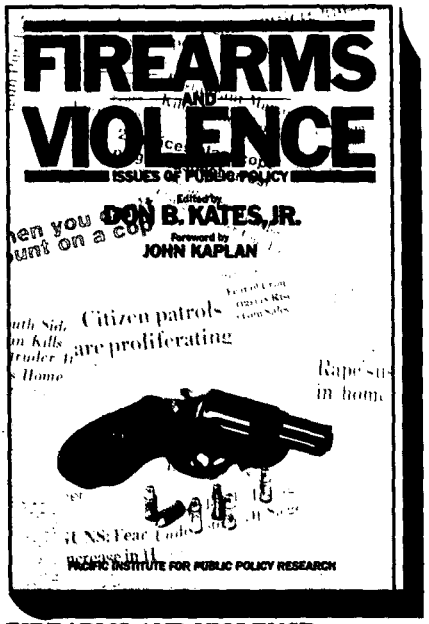

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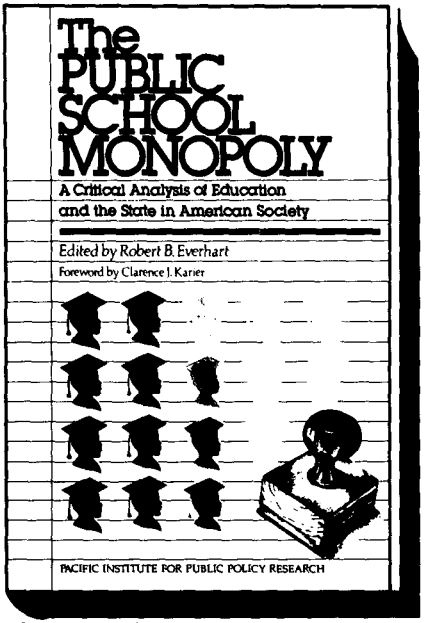

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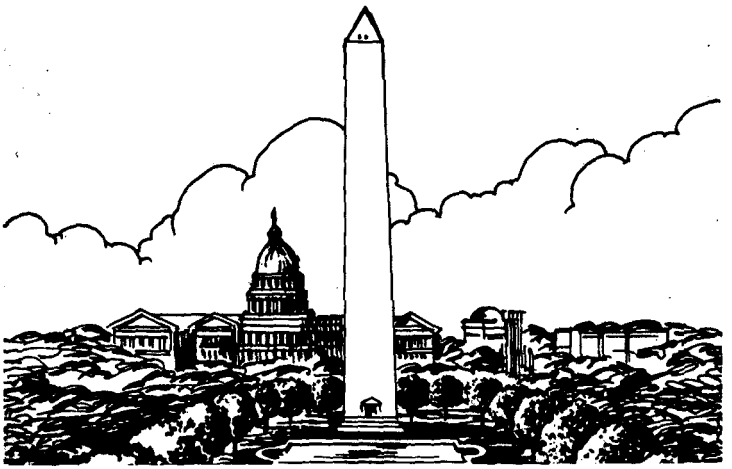

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Soviet Marshal Nikolai V. Ogarkov
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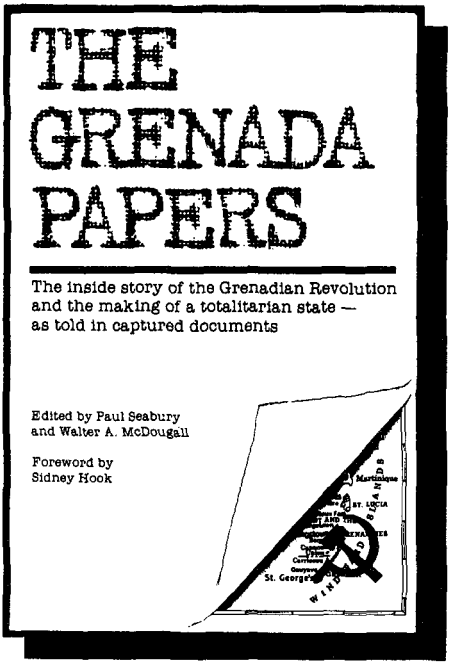
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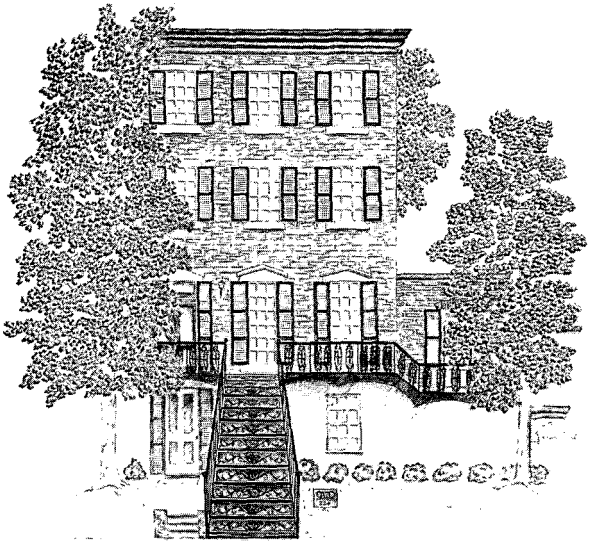

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—Charles L. Schultze

"Industrial Policy: A Dissent,"
The Brookings Review
2 (Fall 1983): 11.

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